September 11, 2020 11:47 PM GMT

Global Macro Strategist | Global

Failing Fiscally

Very few expect failure when heading back to school, but markets have doubts about pre-election US fiscal stimulus. Uncertainty over fiscal policy should pass the baton to uncertainty over the US election and Brexit – keeping markets range bound. Fiscal failure could bring more Fed easing.

Interest Rate Strategy

We exit 5y TIPS/30y UST yield curve steepeners, and maintain long 5y TIPS outright. We lower our UST yield forecasts. We maintain long 10y BTPs vs Short 10y German Bunds, long 10y Netherlands vs short 10y German Bunds and short UKT 30s vs long 30y DBR 30s. Exit JGB 7s30s steepeners and long 10y AUD JGB ASW, and change JGB 5s20s flattener to long 20y JGB vs pay 2y swap, enter long 10y USD JGB ASW. We update our rates forecasts and close our Canada 2s10s steepener.

Currency & Foreign Exchange

We see an increased probability of hard Brexit and update our GBP views. USD correlation to equities breaks down when relative US equity outperformance exceeds the 90th percentile. We investigate how mobility has been affected by the recent resurgence in Covid-19 cases and the implications for G10 FX. Long EUR/NOK 3m call spreads as a hedge for US election volatility. EUR/SEK and USD/CAD should trade sideways.

Inflation-Linked Bonds

We continue to suggest staying long 5y TIPS, and 30y breakeven wideners. We take a deep dive into inflation trends and suggest why weakness in rent inflation should not bog down bullish TIPS investors.

Short-Duration Strategy

We answer common questions investors have been asking since Vanguard decided to switch a prime MMF to a government MMF. While we don't think the switch will have direct impacts on unsecured funding markets, the risk is that other large MMFs follow suit, driving FRA/OIS wider.

Interest Rate Derivatives

We still suggest long 3m10y ATMF straddles, delta hedged, as upper right vol should perform on uncertainties surrounding the timing and sizing of a stimulus package, and realized vol picking up going into the US election.

Technical Analysis

Mixed weak trends in G10 rates. In G10 FX, medium-term trends remain DXY bearish, EUR bullish vs. GBP, CHF, JPY; AUD bullish vs. USD, NZD, CAD.

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Global Macro Strategy

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Interrupted by Fiscal Failings

In early August, we discussed our vision for how risky assets would perform through October (see The Path to the Election). In short, we had expected risk taking to remain robust in August and September, then pare back in October as the election neared. The risks to this view included "fiscal failure" and a Fed that didn't deliver on average inflation targeting (AIT).

While the Fed largely delivered on our expectations for flexible average inflation targeting (FAIT), it left those wanting promises of more accommodation in the near term disappointed (see Jackson Hole: A Historic Moment, But Not For All). While Fed Governor Brainard's September 1 speech initially boosted hopes, we read her speech as downplaying any chance of additional monetary accommodation in the near term (**our emphasis**):

> *With the recovery likely to face COVID-19-related headwinds for some time, **in coming months**, it will be important for monetary policy to pivot from stabilization to accommodation.*

Furthermore, Brainard made it clear that she wanted to see how fiscal stimulus played out before committing to more on the monetary side:

> *While the virus remains the most important factor, the magnitude and timing of further fiscal support is a key factor for the outlook.*

As such, without further monetary stimulus from the Fed, or the ECB for that matter, investor attention turned to US fiscal policy, which hadn't progressed throughout all of August. Those following the negotiations closely began to reassess prospects for fiscal stimulus after the US Labor Day. Those familiar with the book *Superforecasting: The Art and Science of Prediction* by Philip Tetlock, will remember the "superforecasters" who are featured throughout the book.

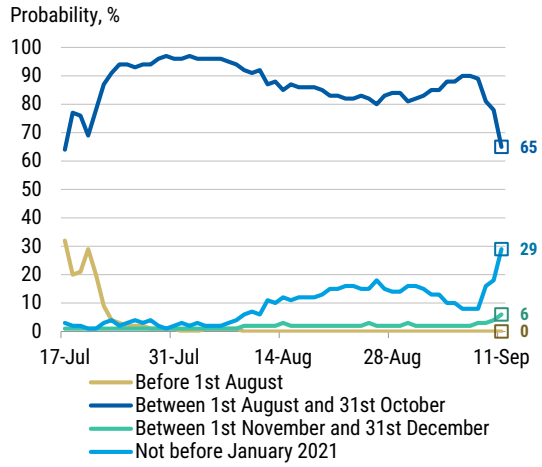
After the US Labor Day, this group of individual forecasters began lowering the probability on a >=$750bn fiscal package before the US presidential election (see Exhibit 1 and the source of the data). As of Friday morning, September 11, the group places a 65% probability on stimulus by the election, but confidence in its passage is falling fast.

The lack of fiscal stimulus and the upcoming US presidential election have begun to weigh on risk-seeking activity earlier than we expected. As discussed in US Election: Waiting Is the Hardest Part, we think investors will need to prepare for an outcome that keeps uncertainty elevated beyond Election Day itself.

The key driver of our view on how long the post-Election Day uncertainty will last is the polling gap between President Trump and former Vice President Biden. The tighter the polls going into the election, the longer the wait may be. In the RealClearPolitics general election polling average, Biden has a 7.5pp lead, while the RealClearPolitics betting odds puts a Biden victory at 53%.

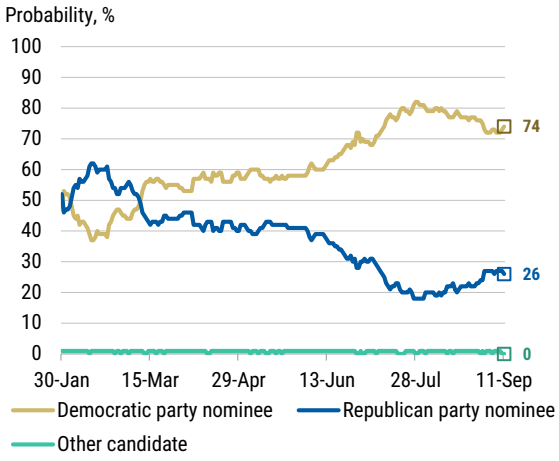
These odds contrast with the Superforecasters who give Biden a 74% probability of winning (see Exhibit 2); this is in line with the FiveThirtyEight projection at 75/100.

Exhibit 1: When will a piece of federal legislation providing for $750 billion or more of new fiscal stimulus become law in the US?



Source: Goodjudgment.com

Exhibit 2: Who will win the 2020 United States presidential election?



Source: Goodjudgment.com

This array of information on the election outcome will keep uncertainty about it elevated. Coupled with dejection on fiscal stimulus, **this should prevent the US Treasury curve from steepening as much as we thought before, prevent TIPS breakeven inflation rates from rising as much, and make further USD depreciation difficult**, in the absence of building expectations for more Fed easing.

Naturally, investors won't be the only group affected by the lack of additional fiscal stimulus. As Brainard's quote above suggests, **the Fed will have to consider what a fiscal hiatus means for the economic outlook**, especially in the wake of the presidential election. How and when could the election influence Fed views? We read historical FOMC transcripts to get an idea.

Exhibit 3 shows that the amount of FOMC participant discussion regarding the election varies from election year to election year. This year, we suspect the focus will be at least as high as 2012, 2004, and 1992 - all years when Fed policy rates were near local lows.

When FOMC participants do talk about the election, they don't talk about it very much until the meeting before the election itself. Then after the election, they discuss it the most (see Exhibit 4). Given the Fed meets immediately after the November 3 election day (on November 4-5), what are they likely to talk about at that meeting? Our transcript reading revealed:

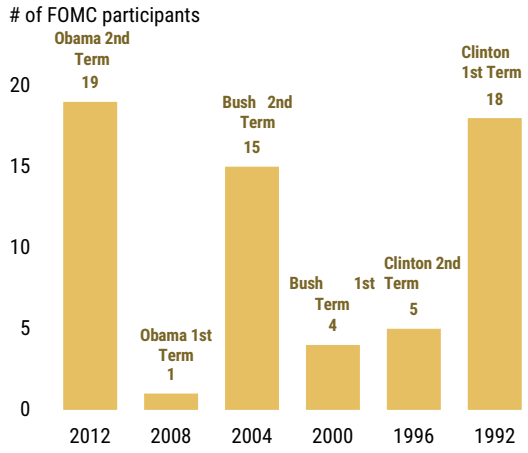
- FOMC participants most often brought up presidential elections in the context of the uncertainty that elections brought to consumers and businesses.
- Apart from uncertainty, the biggest issue mentioned by FOMC participants in relation to presidential elections was the impact elections have on fiscal policy and how markets reacted to expected changes in fiscal policy.
- For some FOMC participants, presidential elections were more important for their impact on consumer and business confidence following the election (the "post-election phenomenon") than in the year leading into the election.

Of course, if the outcome of the election is still unknown by November 5, FOMC participants could spend less time on these issues.

Instead, their discussions might involve the length of time for the outcome to be known; how the prolonged uncertainty over the election result could weigh on consumer, business confidence, and spending; and how the lack of fiscal stimulus – surely to be extended by political contention – could weigh on economic activity.

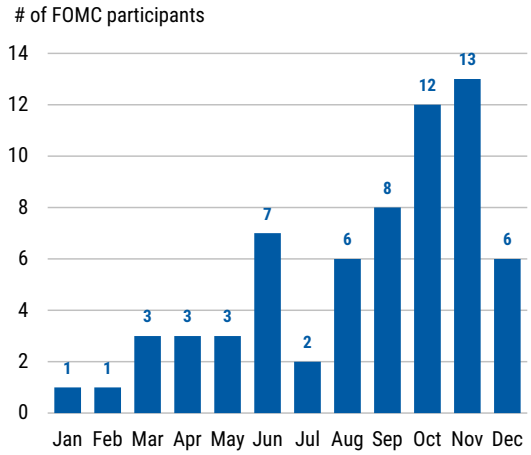
All of this could put Fed policy on course for additional easing, with consequences for rates and FX markets, e.g., a flatter Treasury yield curve, lower real yields, and – eventually, once election uncertainty subsides – a weaker USD.

Exhibit 3: Cumulative number of FOMC participants mentioning the presidential election each of the following election years: 1992, 1996, 2000, 2004, 2008, and 2012



Source: Morgan Stanley Research, Federal Reserve

Exhibit 4: Cumulative number of FOMC participants mentioning the presidential election each month of these election years: 1992, 1996, 2000, 2004, 2008, and 2012



Source: Morgan Stanley Research, Federal Reserve

Of course, before September ends, equity markets could "convince" Washington to pass another round of fiscal stimulus, with different consequences for rates and FX, e.g., a steeper Treasury curve, wider inflation breakevens, and a weaker USD. **In the end, the US presidential election notwithstanding, the path for US fiscal policy – and its implications for the near-term future of Fed policy – is the most important factor in macro markets.**

Fiscal Stimulus and the USD

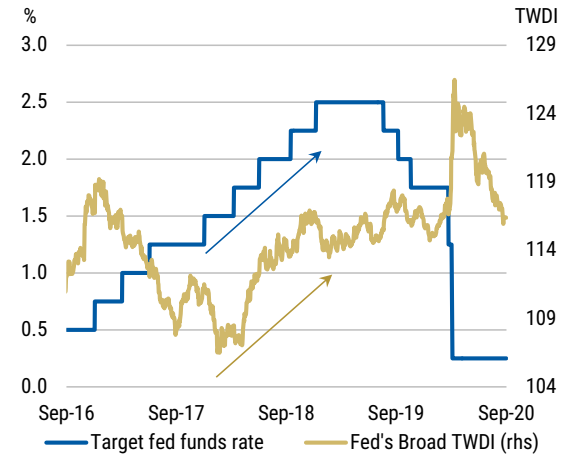
For the US dollar, is all US fiscal stimulus created equal? One might conclude that another round of stimulus would carry the USD higher, like it did throughout 2018, as US growth strengthened. However, we see a completely different macro backdrop, as well as Fed policy, as confounding that conclusion.

First, and most obviously, the Fed kept tightening policy in 2018, encouraged by the late-cycle fiscal stimulus (see Exhibit 5). In 2021 and 2022 certainly, and perhaps beyond that, fiscal stimulus alone will not cause tighter monetary policy. Inflation would have to be running above 2% for some time, given the Fed's new policy framework, before fiscal policy would have a 2018-style impact on the Fed (see The Fed's New Framework: This Time Is Different).

As a result of the Fed's new framework, we think more fiscal stimulus today would have a different impact on real yields and breakeven inflation rates than in 2018. The Tax Cuts and Jobs Act (TCJA) pushed breakevens higher initially, but tighter Fed policy took the wind out of their sails (see Exhibit 6). At the same time, tighter Fed policy helped real rates trend toward decade-long highs, encouraging USD strength.

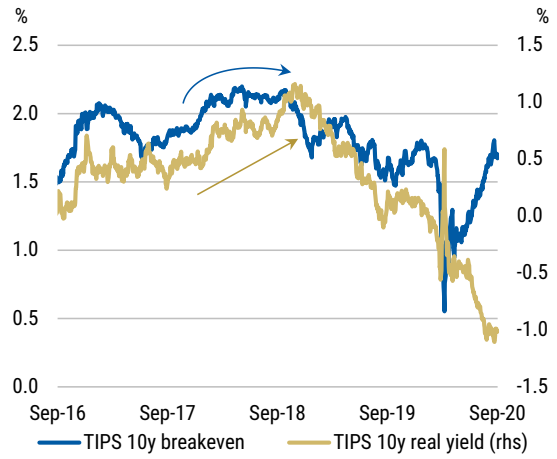
Fiscal stimulus today would not only move breakeven inflation rates higher, but continued easy Fed policy would sustain the trend, at least until realized inflation sustained levels above 2%. This would, at a minimum, keep a lid on real rates, which are nearly 200bp lower than in 2018 already. At a maximum, this could place much more downward pressure on real rates, and send the USD ever lower.

Exhibit 5: The Fed's broad trade-weighted USD index and its target fed funds rate



Source: Morgan Stanley Research, Federal Reserve

Exhibit 6: US TIPS 10y real yields and breakeven inflation rates



Source: Morgan Stanley Research, Federal Reserve

Our Current Stance on Markets

In global rates markets, in the US we suggest exiting steepeners constructed in two ways: long 5y TIPS vs short 30y nominals and long 5y1y UST vs short 30y nominals. We continue to suggest being long 20s on a 10s20s30s fly, long 5y TIPS outright, and long 30y breakevens. In US rates vol, we maintain long positions in 3m10y straddles, delta hedged.

In the euro area, we suggest staying long 10y BTPs vs. short 10y Bunds, long 10y Netherlands vs. short 10y Bunds, and short 30y Gilts vs. long 30y Bunds.

In Japan, we suggest exiting JGB 7s30s steepeners and long positions in 10y AUD-denominated JGB ASW. We shift from JGB 5s20s flattener to long 20y JGB vs paid positions in the 2y swap. We also enter long 10y USD-denominated JGB ASW.

In New Zealand, we continue to suggest NZD 10y swap spread tighteners, long September 2040 NZGB IIB, and 2s10s NZGB flatteners. In Australia, we continue to suggest long positions in the April 2024 ACGB with a limit order to buy the April 2023 ACGB at 30bp. In Canada, we suggest exiting CAGB 2s10s steepeners, but we continue to suggest 10y swap spread wideners.

In foreign exchange markets, we maintain a structural bearish skew to our outlook for the USD, though we remain tactically neutral.

In Europe, our medium-term view remains USD bearish, but we recommend staying neutral EUR/USD. We continue to hold 1.0760 EUR/CHF puts (with mid-Jan 2021 expiry). We expect GBP/USD to trade sideways between now and end-October, but expect it to be volatile. We no longer suggest long GBP/SEK.

In the dollar bloc, we remain neutral on AUD/USD, NZD/USD, and USD/CAD given we are tactically neutral on the US dollar. We remain long AUD/NZD with a target of 1.1200 a stop of 1.0550. We are no longer short USD/CAD since we hit our target of 1.3100.

Interest Rate Strategy

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United States

We suggest investors take off the curve steepeners we had suggested - i.e. long 5y TIPS vs. short 30y nominals, and long 5y1y UST vs. short 30y nominals, as our conviction for higher back-end Treasury yields has decreased. We continue to suggest being long 5y TIPS outright. We see five reasons to exit curve steepeners (1) less likely that fiscal stimulus matches our base case (2) underwhelming fiscal support marginally increases chances of Fed thinking duration extension in QE (3) possibility (but not our base case) of a shift lower in the long run dot in September to signal a structurally dovish shift for AIT (4) historical precedent for rates to move sideways from the September FOMC to the Presidential election, and (5) an uncertain election period could increase the flight-to-quality bid in Treasuries.

We lower our Treasury yields forecasts - we now see 10y yields ending 2020 at 0.95%, instead of 1.15%. The lower forecast accounts for 3 things that have changed vs. June (1) the fed has bene more dovish via a shift towards average inflation targeting and has also signaled an implicit cap on yields (2) higher probability of disappointment on fiscal stimulus and (3) increased election uncertainty driving a flight to quality premium in Treasuries.

Euro area

In the euro area, we lower our 10y Bund yield forecast to -30bp from -10bp previously and look for notably less steepening pressure into year-end in the DBR 2s10s, 5s30s and 10s30s curves relative to our mid-year forecasts. In the near term, we have a more constructive view on the outlook for euro area duration, including outright periphery duration.

We think that our full-year supply estimates for coupons ex bills may prove too high in a number of countries across the euro area, including but not limited to Italy and Germany. In Italy specifically, we think there may be a case for lower supply needs during the remainder of 2020 given 1) a strong Treasury account balance at the end of August, 2) upcoming SURE money disbursements (which may be slightly smaller in 2020 given the delayed start until mid-October), 3) a strong improvement in budget data and tax receipts, and 4) better economic growth than expected. We update our forecasts for funding progress by country. Finally, we investigate how 10y Bund futures have performed historically for the remainder of the calendar year after the rare instance when the return on a 10y Bund future was actually negative during the combined July/August period.

United Kingdom

In the UK, the higher probability of a hard Brexit that our economists now foresee joins an already growing list of unanswered autumn uncertainties such as the expiration of the furlough scheme, talk of possible tax increases, the timing and content of the autumn budget, upcoming issuance needs and the outlook for additional COVID-19 measures. With answers to many of these uncertainties perhaps still weeks and months away, gilts once again appear susceptible to persistent headline risk for the last few months of the year.

We see the battle in the gilt market as squarely between heightened uncertainty and significant supply, with both likely to have an impact. The increase in Brexit uncertainty has led to a repricing of MPC rate cut probabilities, with a move to negative Bank Rate now priced in to a greater extent than even prior to the August MPC meeting.

For this reason, we suggest investors move away from UKT 2s5s steepeners, given the strong correlation between the 2s5s curve and deep inversions in longer-maturity MPC OIS versus Sonia. However, we continue to like cross-market 30y gilt shorts versus longs in 30y Bunds and/or expressions that look for greater steepening pressure in the UKT 10s30s curve relative to the DBR 10s30s curve.

Finally, we investigate how 10y gilt futures have performed for the remainder of the calendar year in the past after the rare instance when the return on a 10y gilt future was actually negative during July/August combined. We found that in 100% of past instances the 10y Gilt future rallied in September following a weaker summer for duration. However, performance in Q4 was a bit more mixed.

Japan

With the heavy long-end supply schedule now out of the way, we turn bullish for long-end duration. Global markets now have shifted into "risk off" mode on the back of less optimism on US fiscal stimulus and lower expectations for the upcoming FOMC meeting. The long-end supply/demand situation has also turned favorable with no further issuance of the new super-long JGBs slated until the 40y auction on September 24. Our basic expectation is that the super-long sector will have little difficulty holding its own through at least the end of the month, and that the JGB yield curve is, if anything, more likely to exhibit a bull-flattening bias. We close our JGB 7s30s steepener, and shift our JGB 5s20s flattener to long 20y JGB vs Pay 2y swap. We also close our long 10y AUD denominated JGB ASW as the level no longer looks cheap vs history.

Dollar bloc

We use this opportunity along with our US rates colleagues to update our forecasts for Canada, Australia, and New Zealand bond yields. Broadly speaking, our framework for interest rates in the three countries remains the same - the key drivers remain central bank policy actions, fiscal policy, and the path for US interest rates given the high correlation of dollar bloc rates to the US Treasury curve (particularly in the longer end).

We also affirm our core views in these markets and our trading recommendations. **In New Zealand** we continue to suggest 2s10s flatteners, remaining outright long the September 2040 IIB, and positioning for 10y swap spread tighteners, as the RBNZ's continued asset purchases should put further downward pressure on long end yields both relative to the front end and relative to swaps.

In Canada, we remove our 2s10s Canada steepener recommendation in line with our line with our US rates colleagues expectation that long-end US yields have limited room to rise. *Ceteris parabis*, we continue to expect substantial Canadian issuance to put upward pressure on long end Canadian yields as the Canadian Department of Finance lengthens the WAM of its issuance. As a result, we continue to suggest investors maintain Canada swap spread wideners. However, long-end Canadian yields are unlikely to rise meaningfully in the absence of US curve steepening.

In Australia we remain neutral on the long end of the curve, which remains caught between the yield positive macro forces like the V shaped recovery, and yield negative forces like foreign inflows into Australian fixed income and the RBA potentially stepping in to check an undue rise in yields. We think there is more value in trading the front end. We continue to suggest buying the April 2023 ACGB at a level of 30bp if reached (limit order), and continue to see value in being long the April 2024 bond, which should continue its trend toward 25bp, the RBA's 3y YCC target.

United States | Exiting curve steepeners; Lower Treasury forecasts

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Taking off yield curve steepeners

We entered yield curve steepeners tactically in late July, after the July FOMC, when yields were near their local lows, and the July FOMC had suggested no imminent changes to the Fed's Treasury QE, while keeping the door open to an average inflation targeting (AIT) framework. Through August, the Fed solidified its foray into AIT, with an update to the long-run policy goals document at the Jackson Hole conference in late August, helping 5y real yields decline and 30y nominal yields rise (see Exhibit 7).

At this point we suggest investors take off the curve steepeners we had suggested – i.e., long 5y TIPS vs. short 30y nominals, and long 5y1y UST vs. short 30y nominals – as our expectations for a near-term rise in 30y yields has diminished. We continue to suggest that investors hold the long 5y TIPS trade outright, as well as 30y breakeven wideners (see United States | Don't get bogged down by rent inflation).

Five reasons the arguments for a curve steepener have diminished :

1. **Fiscal stimulus of the size we expected looks less likely, if fiscal stimulus comes at all:** While our base case continues to be a sizeable fiscal stimulus, headlines suggest that the eventual size of fiscal stimulus is likely to fall short of our 1.5-2 trillion estimate. Given the length of negotiation so far, it is also possible that a fiscal package may not come before the election. Without fiscal stimulus, the growth impulse, and the argument for higher supply --> higher yields does not work. If the Congress does announce fiscal stimulus of meaningful size, we will reconsider getting into curve steepeners.

2. **Underwhelming fiscal support marginally increases the chance of Fed easing via QE:** The July FOMC minutes have suggested that fiscal response is the main tool to support the economy, while the Fed keeps conditions easy by holding low rates. However, if fiscal response is delayed, we think the Fed might be more willing to consider extending duration as a means to provide more easing, especially now that they are framing asset purchases in the context of financial conditions.

3. **A possibility of the lowering of the longer-run dot – to support the structural dovish shift consistent with AIT – is a possibility at the September FOMC:** While it is unlikely (and not our base case) that the Fed will be changing its longer-run dot at the September FOMC, it remains a risk. The median longer-run dot could go lower, if the Fed believes that longer-run rates are going to be structurally lower to support an average inflation target of 2%, which could then drag Treasury yields lower in the back end (see Exhibit 8).

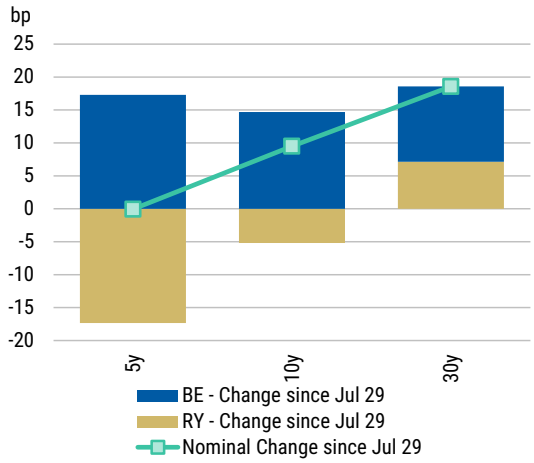
4. **Historical trends from September FOMC to election support a neutral stance on the back-end:** Historical price action from 3 days after the September FOMC (to account for the post-FOMC reaction) to the date of the US election shows that, over the last six election cycles, rates tend to tread water/stay range-bound heading into the election. Of the last six presidential election cycles, only in 2016 were yields higher between the September FOMC and the election, by ~20-30bp.

5. **Special 2020 election dynamics support flight to quality:** We think a move higher in yields is particularly unlikely in this election cycle, given the dynamics of the considerable increase in likely mail-in votes, and consequent delays in tallying results. We think there will be a period of uncertainty around Election Day, and a flight-to-quality bid in Treasuries. Note that the swaption volatility market is already pricing in the potential for multiple days of higher volatility (see Exhibit 10) – in line with our expectation for a longer-than-usual vote-counting period.

The flight to quality in US Treasuries could increase non-linearly with time. The more time it takes to get a final (and certain) result, the more the flight-to-quality bid could increase non-linearly. The longer it takes to get the result increases the probability the vote-count is close, which could then signal that we're headed toward a divided government outcome. Exhibit 11 shows that Treasury yields tend to decline in divided outcomes, while they rise in united government outcomes.

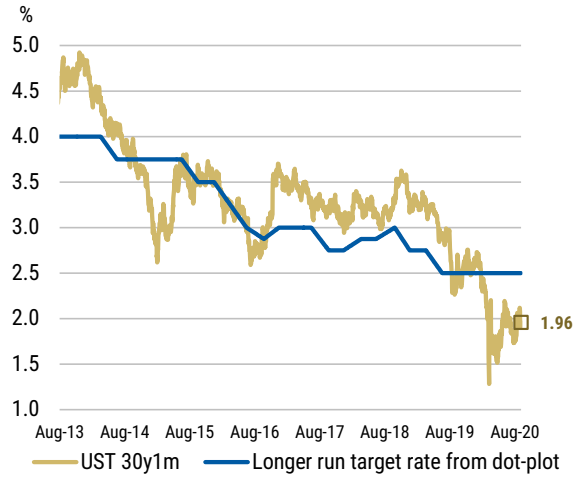
We suggest owning 3m10y straddles delta-hedged heading into the election to account for the increased volatility associated with the coming election (see United States | A 1-2 Punch for Upper Right Vol).

Exhibit 7: Moves in real yields, breakevens and nominals since July FOMC (July 29)



Source: Bloomberg, Morgan Stanley Research

Exhibit 8: UST30y1m vs. the Fed's longer-run dot



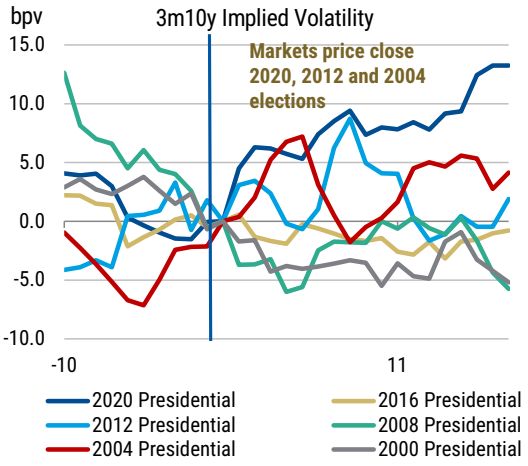
Source: Bloomberg, Morgan Stanley Research

Exhibit 9: Moves in 10y and 30y yields from 3 days post-September FOMC to presidential Election Day

Election cycle	3 days post FOMC	Presidential Election	10y yield move (bp)	30y yield move (bp)
2016 Presidential	26-Sep-16	8-Nov-16	27	30
2012 Presidential	18-Sep-12	6-Nov-12	-6	-9
2008 Presidential	19-Sep-08	4-Nov-08	-9	-19
2004 Presidential	24-Sep-04	2-Nov-04	2	1
2000 Presidential	6-Oct-00	7-Nov-00	5	6
1996 Presidential	27-Sep-96	5-Nov-96	-41	-32
Average			-3	-4

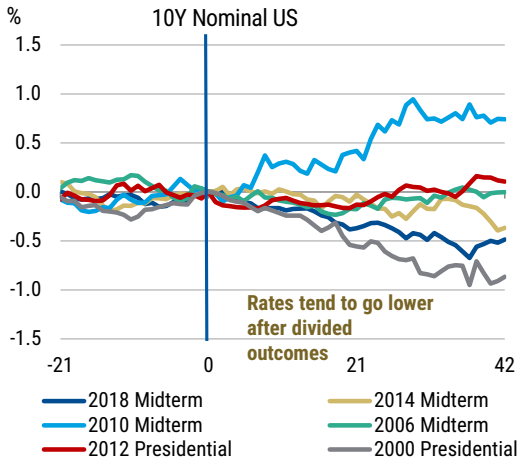
Source: Bloomberg, Morgan Stanley Research

Exhibit 10: Implied volatility in 3m10y swaption as it picks up the election date



Source: Bloomberg, Morgan Stanley Research

Exhibit 11: 10y yields in response to divided government outcomes



Source: Bloomberg, Morgan Stanley Research

Revising lower our Treasury yield forecasts

We see 10y Treasury yields at just below 1% by the end of 2020, slightly lower than our 1.15% forecast in June. We see 10y yields at 0.95% to end 2020, essentially at the higher end of its 50-90bp range over the last six months. We see 5y and 30y yields lower vs our previous forecast, and the curve slightly steeper as well. So what has changed vs. June? Three things:

Exhibit 12: Morgan Stanley Treasury yield forecasts

	Current	4Q20	2Q21	4Q21
2Y	0.15	0.15	0.15	0.20
5Y	0.30	0.45	0.50	0.60
10Y	0.70	0.95	1.00	1.20
30Y	1.48	1.75	1.85	2.05

Source: Bloomberg, Morgan Stanley Research

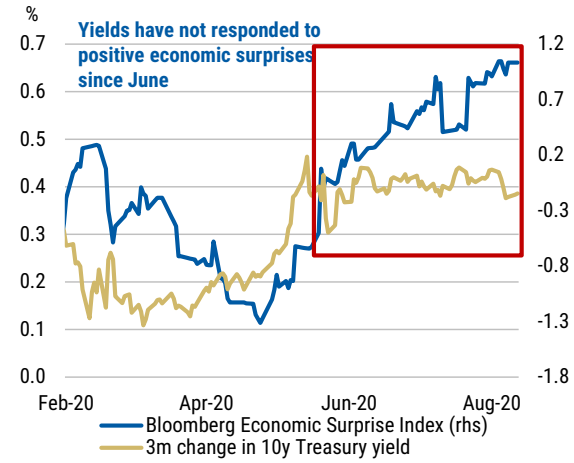
1. The Fed has been more dovish than market expectations with (1) explicit average inflation targeting (AIT) as their new framework, (2) setting a very high bar for economic data, and (3) keeping the possibility of more QE/duration extension alive, even though not imminent. We had envisioned the market would have to "fight the Fed" to drive yields higher – and that has turned out tougher than we thought, given the frequency of dovish messages. In other words, **the Fed's implicit yield curve control has made it harder to see Treasury yields moving much higher from current levels.**

One way to see how well the implicit yield curve control has worked is to look at the lack of movement in Treasury yields even as (1) economic data have continuously surprised to the upside in recent months (see Exhibit 13) and (2) risky assets have performed well (see Exhibit 14). Mathematically, this disconnect in Treasury yields relative to economic fundamentals and risk markets reflects the decline in real yields, even as breakevens have responded well to better data and risk markets progress. Our equity strategists see the near-term fair value at S&P500 at 3425, very close to current levels, and economic surprises are more likely to pause than continue from these lofty levels, given the typical mean-reverting of economic surprises over history. We think these dynamics will make it harder to achieve the yield levels we had envisioned in June.

2. Fiscal stimulus prospects have diminished, limiting the growth/supply tailwind: As we discuss above, current headlines suggest that it is possible that the US Congress may not be able to agree on a fiscal stimulus package before Election Day. While these headlines could just be noise before an eventual deal, an agreed-upon deal is likely to be on the lower side of our $1.5-2.0 trillion assumption. This will limit the fiscal impulse into growth, and also weaken the Treasury supply argument for back-end rates.

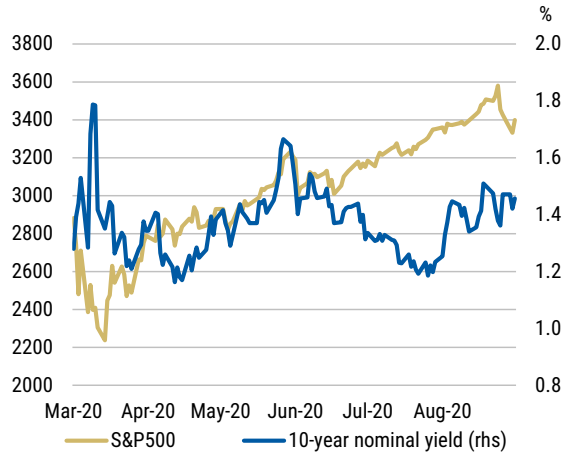
Powell, in response to a question on YCC: *The sense of it is, that if rates were to move up a lot, for whatever reason, and we wanted to keep monetary policy accommodative we might think about using it. Not on the whole curve, but on some part of the curve. And it's not a decision that we've made, it's sort of an early stage thing we're evaluating.*

Exhibit 13: 10y Treasury yields vs. Bloomberg economic surprise index over the last six months



Source: Bloomberg, Morgan Stanley Research

Exhibit 14: 10y Treasury yields vs S&P500 over the last six months



Source: Bloomberg, Morgan Stanley Research

3. Election uncertainty has increased, supporting flight-to-quality premium in Treasuries: Chances of a "normal election" have slimmed further, and mail-in voting is likely to be major chunk of the vote. As we wrote in our recent election note, the uncertainty around the election period is likely to keep some flight-to-quality premium in Treasuries.

Trade idea: Maintain long 5y TIPS at -132bp
Trade idea: Close 5y TIPS/30y UST steepener at 272bp
Trade idea: Close 5y1y UST/30y UST steepener at 48bp

Euro area | Lowering Bund yield forecasts, update on supply

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Lowering Bund Yield Forecasts, Less 10s30s Steepening Pressure

We lower our year-end 2020 10y Bund yield forecast to -30bp from -10bp. We look for less steepening pressure into year-end in the DBR 2s10s, 5s30s and 10s30s curves relative to our mid-year forecasts published in the Global Macro Strategy Mid-year outlook. We like being in 10s30s flattener expressions in German Bunds relative to 10s30s curves in markets such as UK Gilts and US Treasuries, where long-end supply post central bank buying is likely to be substantially more meaningful than in the euro area broadly.

In the near term, we have a more constructive view on the outlook for euro area duration, including outright periphery duration. Importantly, these views are also supported by past price analogues looking at performance across German, UK, and US 10y Treasury futures after a softer summer as well as our momentum-based models found in A "Smarter" Beta Way To Trade G4 Futures Duration?, which extended long positions in all three of these markets this past week.

We think that our full-year supply estimates for coupons ex bills may prove too high in a number of countries across the euro area, including but not limited to Italy and Germany. In Italy specifically, we think there may be a case for lower overall supply needs during the remainder of 2020 given 1) a strong Treasury account balance at the end of August, 2) upcoming SURE money disbursements (which may be a bit smaller in 2020 given the delayed start until mid-October), 3) a strong improvement in budget data and tax receipts in recent months, and 4) better economic growth than perhaps initially expected.

We see this as contributing to a potentially larger negative net supply dynamic for coupons ex bills than we have been conservatively envisioning for the remainder of 2020 and into 2021 after accounting for redemptions, ECB buying, and EU SURE/NGEU monies.

Additionally, we see less pressure for steepening in core euro area 10s30s curves relative to other markets. We think that a considerable portion of long-end supply has been finished for the year and see the likely reduced amount of 2020 EU SURE debt that is issued in coming months as being more concentrated in the 7-15 year parts of the curve rather than the long end, as we discussed in EU SURE Details Emerging.

However, risks to this lower Bund yield outlook do remain in both 2020 and 2021. For example, Germany may choose to continue to issue aggressively in 4Q 2020 and shift more of the issuance towards longer maturities. Additionally, Germany could choose to roll heavy 2020 Bubill supply into longer maturities in 2021, which would be similar to what was observed following the GFC and would result in similar levels of coupon issuance even if overall issuance may end up lower.

Additionally, the overall supply of higher rated paper will be rising in the euro area as the EU starts to issue more aggressively in the coming months and years. As we have stated previously in An Alternative to Bunds?, we think it is likely that some investor bases look to move away from higher rated names like Germany, the Netherlands, and Finland towards the EU's higher yielding but nearly identical credit quality paper. This is why we maintain some bias for higher 10y Bund yields from current levels, although this story has been reduced in 2020 with the start of EU SURE issuance now pushed back until at least mid-October.

Exhibit 15: Morgan Stanley DBR forecasts: Base case

Base	Current	4Q20	1Q21	2Q21	3Q21	4Q21
2y	-0.70	-0.65	-0.65	-0.60	-0.55	-0.55
5y	-0.69	-0.65	-0.60	-0.55	-0.45	-0.40
10y	-0.48	-0.30	-0.20	-0.10	0.00	0.10
30y	-0.04	0.05	0.20	0.35	0.45	0.65

Source: Morgan Stanley Research forecasts

A summary of why we are lowering our Bund yield forecast and why we see less steepening pressure relative to other markets with larger long-end supply:

- significantly lower YoY levels of core, supercore, and headline inflation than in 4Q 2019 and a benign inflation outlook in coming months
- possible signalling of further easing by the ECB, including the potential for a PEPP increase and push back of PEPP forward guidance
- a shorter duration profile for the EU SURE issuance, resulting in less long-end-related concession activity. Additionally, the start of SURE issuance has been pushed back to mid-October, suggesting possibly less 2020 issuance, based on the most recent EU Investor Presentation.
- reduced funding need expectations for many euro area sovereigns, including Italy and Germany, relative to our forecasts for the remainder of 2020. Continued statements that Germany may look to move back to budget neutral by 2022.
- price analogues that suggest a near-term bias for long duration post a weaker summer for duration and rules-based trading strategies that continue to remain in maximum long-duration positions
- general uncertainty associated with Brexit negotiations, the US Presidential election, and the potential for COVID-19 related lockdown measures.

We look for tight correlations in core euro area markets to persist between moves in 10y yields and 2s10s curves and moves in 30y yields and 5s30s curves. Risks to our year-end 2020 Bund yield forecast include a shift in 4Q 2020 issuance towards longer maturities, an expectation for a rolling of heavy 2020 Bubill issuance into longer maturity coupons in 2021, and possible substitution away from Bunds towards EU debt (although this has become more of a 2021 story with start of SURE issuance delayed until at least mid-October).

In the bear case for German Bunds, economies in Europe and globally recover significantly faster than expected while core inflation rebounds, leading to some speculation that the ECB may start the process of signaling an end to both PEPP and eventually APP purchases. The EU/UK reach a Brexit trade agreement and a COVID-19 vaccine becomes widely available across the continent.

Exhibit 16: Morgan Stanley DBR forecasts: Bear case

Bear	Current	4Q20	1Q21	2Q21	3Q21	4Q21
2y	-0.70	-0.55	-0.50	-0.45	-0.40	-0.35
5y	-0.69	-0.50	-0.45	-0.35	-0.30	-0.10
10y	-0.48	-0.10	0.00	0.20	0.35	0.50
30y	-0.04	0.40	0.60	0.75	0.85	1.00

Source: Morgan Stanley Research forecasts

In the bull case for German Bunds, Europe slips back into another series of COVID-induced lockdowns, and there is a hard Brexit. Market participants become concerned about a further substantial hit to economic growth, deflation, poor risk market performance, and a widening in periphery spreads.

Exhibit 17: Morgan Stanley DBR forecasts: Bull case

Bull	Current	4Q20	1Q21	2Q21	3Q21	4Q21
2y	-0.70	-0.85	-0.90	-0.90	-1.00	-1.00
5y	-0.69	-0.85	-0.80	-0.80	-0.90	-0.90
10y	-0.48	-0.75	-0.80	-0.80	-0.85	-0.85
30y	-0.04	-0.45	-0.5	-0.55	-0.60	-0.60

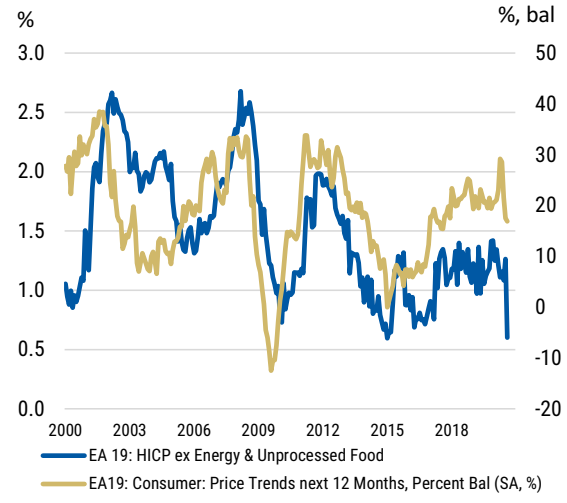
Source: Morgan Stanley Research forecasts

The outlook for inflation, the ECB, and a PEPP top-up

We see a euro area inflation rebound and general steepening pressure as more of a 2021 story at this juncture as fiscal stimulus has a chance to start fully working its way through the global economy, the EU recovery fund monies start to get pushed out to Member States, and DM central banks remain extremely accommodative in pursuit of symmetry around their inflation objectives. Progress towards a COVID-19 vaccine and/or the release of one could speed this trajectory to the extent it coincides with faster economic recoveries.

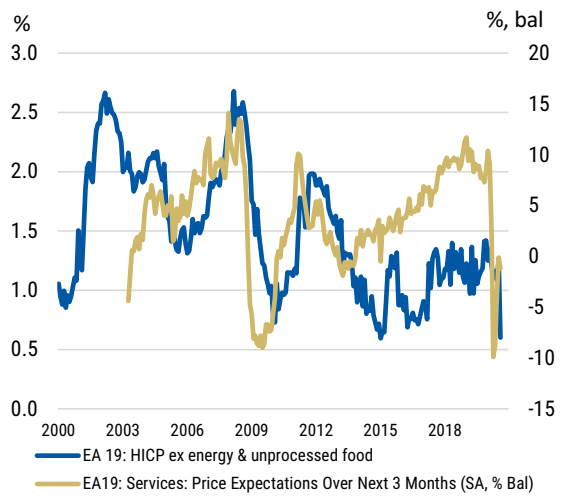
However, in the near-term YoY measures of broader euro area core, supercore, and services price inflation are likely to remain materially below the levels that existed in the last few months of 2019 when YoY core levels were closer to 1.4%. This is a far different YoY outcome and trajectory for core and supercore in the coming months than the one that existed in the back half of last year, potentially meaning that 5y5y inflation swap levels remain around current or lower levels absent a major growth catalyst.

Exhibit 18: EA19 Services Price Expectations Next 3m vs HICP ex energy & unprocessed food



Source: Eurostat, Haver Analytics, Morgan Stanley Research

Exhibit 19: EA19 Services Price Expectations Next 3m vs HICP ex energy & unprocessed food



Source: Eurostat, Haver Analytics, Morgan Stanley Research

The reversal of some administered price changes in 2021 should contribute towards some degree of a rebound in YoY measures next year, but it is still not clear yet whether some of these measures may be extended, similar to many countries worker furlough schemes. Additionally, measures of consumer, services, and retail price expectations have all shown only a very modest rebound despite an improvement in economic activity.

The recent decline in brent crude adjusted for the appreciation of the euro may also delay the recovery in headline inflation leaving the near-term outlook fairly subdued and setting the market up for perhaps a few more months of negative YoY HICP.

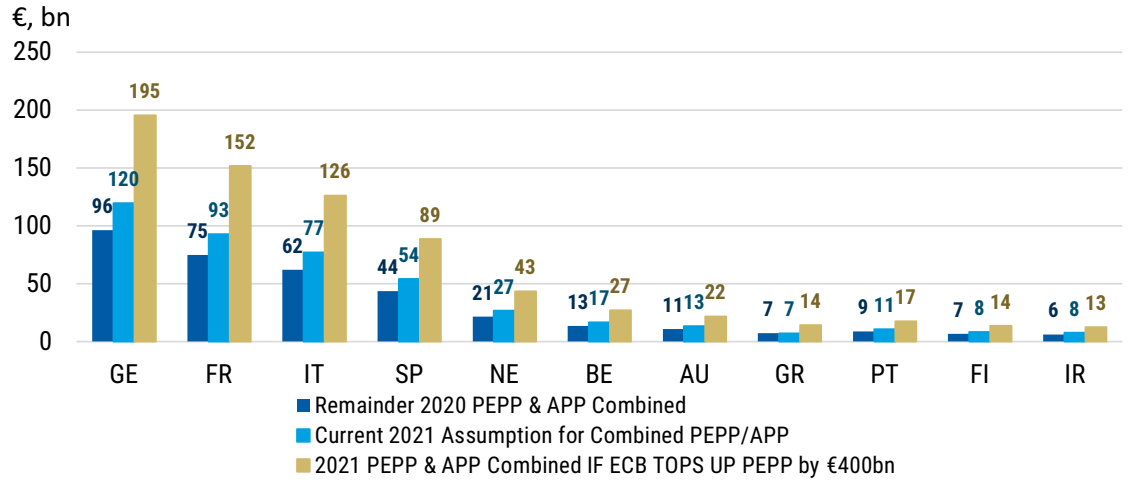
Our economists see this likely inflation scenario, which may not be fully reflected in the ECB's most recent forecasts given the most recent decline in energy prices, as leading to an eventual €400 billion increase in PEPP and an extension of the PEPP forward guidance. We think that this possibility was left open in the latest ECB Blog by Chief Economist Lane following the September 2020 ECB Governing Council meeting.

If our view on supply, the ECB, SURE issuance, and the inflation outlook proves correct, then we see this as an environment that would be consistent with flatter curves and tighter periphery spreads as the market understands the ECB reaction function in relation to the potentially longer period of time it will take to achieve a robust convergence of inflation back to target over the medium term.

For a country like Germany, a PEPP top-up in 2021 could mean an additional €75 billion in purchases throughout the year on top of our current expectations. These expectations assume that the APP runs for the full year at a pace of €20 billion net per month, with 75% of purchases in public sector securities, and that PEPP completes approximately €400 billion in 2020, with 80% in public sector securities.

We would see this as limiting the extent that Bund yields would likely rise given the impact on net supply, particularly since recent commentary from German officials suggest somewhere between €80 to €100 billion in net financing needs in 2021, with a move possibly back to a more balanced budget by 2022.

Exhibit 20: Change in potential 2021 APP/PEPP Purchases IF PEPP increased by €400 billion



Source: ECB, Morgan Stanley Research estimates

10y Bund Future Performance Following a Weaker Summer

Summer months tend to be fairly favorable for German Bund, UK Gilt, and US Treasury duration. In fact, we think this is probably one of the most understood seasonal patterns in the market. However, there have been some instances when summer months historically have had negative returns on a 10y future, and it just so happens that the summer of 2020 turned out to be one of them. Currently, the German Bund market finds itself in the rarest of the three possible outcomes we looked at coming out of the summer months; one whereby the 10y Bund future had a negative return in August and the overall July/August performance was also negative.

Since the early 1990s, there have only been 3 times prior to 2020 when a 10y Bund future return has been negative in both August and July/August combined even though there have been 8 times that the Bund return has been negative in August in isolation (Exhibit 22).We took a look back at when the return for a 10y Bund future was negative in August, negative in July/August combined, or negative in both instances since the early 1990s. Results were similar for both 10y UK Gilt futures and 10y US Treasury futures (reminder that past performance is not a guarantee of future performance). We found the following from our study:

- The month of September had a positive return in 67% of instances when the 10y Bund future had both a negative August return and a combined July/August negative return, while the month of October was positive 100% of the time. September 2020 will count as a positive month if the current on-the-run 10y Bund future (RXZ0) closes above 172.73.

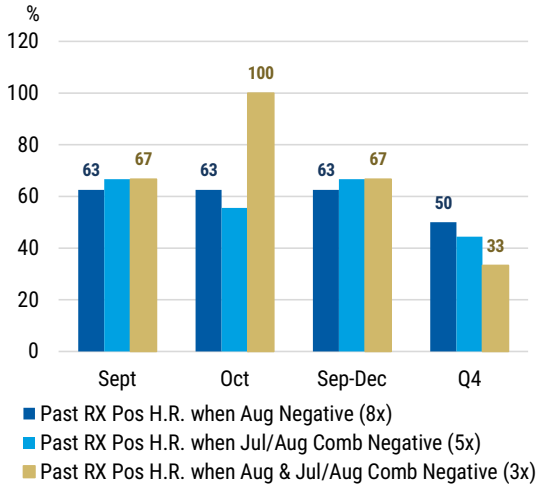
- However, returns for the remainder of the year were more mixed, suggesting that some of the rebound typically seen in September in 10y Bund futures after a softer summer had at least reversed to some extent in the latter parts of 4Q.

- For example, when the August return was negative and July/August combined was also negative historically, the 10y Bund future had a positive return in 4Q only 33% of the time (1 of 3 instances). For the 10y US Treasury future, the return was positive only 40% of the time when this condition was met (it was not in summer 2020 given July/August combined was marginally positive), and for the 10y UK Gilt future the return in 4Q was positive only 50% of the time.

- Finally, the 10y US Treasury future has had a positive return in 100% of Septembers in our look-back period after a negative return in the month of August (6 prior instances and the only of the three scenarios analyzed that applies in 2020) with the same condition applying for 10y UK Gilts. Given the correlation among global rates, we think this is notable.

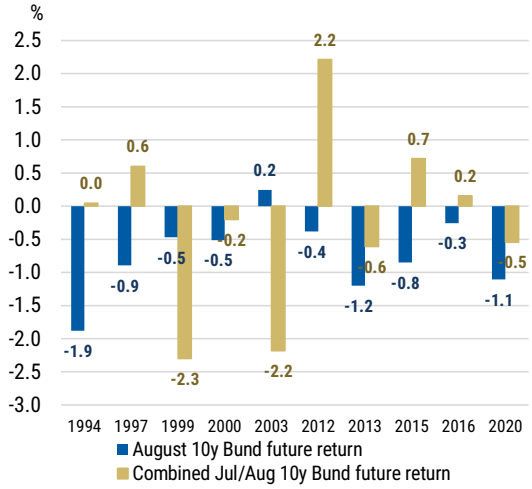
Importantly, these studies are limited by a fairly small number of observations given how rare summer duration weakness tends to be, but we think it important to understand how markets have evolved in the periods after outlier events. We show the positive hit ratio for Bund futures in each of the three scenarios described earlier. If history is a guide and global correlations hold, the studies would suggest that investors looking to set short duration positions should wait until 4Q.

Exhibit 21: Hit Ratio For Positive 10y Bund Future Return After a Negative Return in August, July/August Combined or both



Source: Morgan Stanley Research, Bloomberg, past performance does not guarantee future performance

Exhibit 22: Periods When 10y Bund Future Return was Negative in August or July/August Combined



Source: Morgan Stanley Research, Bloomberg, past performance does not guarantee future performance

EGBs: YTD Funding Progress Update

The updated YTD funding numbers show that a majority of countries have now completed close to 80% of their expected issuance for the year, with Austria and Finland being the closest to completing its planned 2020 funding at close to 90% progress towards the remit.

We also note that the below numbers are not adjusted for the eventual disbursement of SURE monies, where the start of issuance has been delayed until mid-October. We expect SURE disbursements to slightly reduce funding requirements for the year, particularly in the periphery and in Belgium (see SURE Details Emerging). In addition, any positive economic developments may mean our financing need estimates for the year prove too high, with subsequent auctions in 2020 potentially used for pre-funding of the 2021 remit.

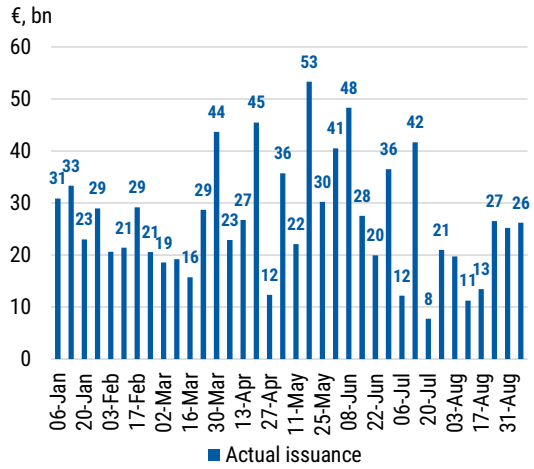
Exhibit 23: Estimated YTD funding progress

	Expected 2020 Issuance, €bn	Issued through Sep 11, €bn	Issuance Remaining, € bn	Issued through Sep 11, % of Expected
Austria	40	34.9	5	87%
Belgium	54	37.0	17	69%
Finland	20	18.1	2	89%
France	278	221.0	57	79%
Germany	264	173.3	91	66%
Ireland	26	21.3	5	82%
Italy	334	254	80	76%
Netherlands	49	30.2	19	62%
Portugal	30	23.8	7	78%
Spain	193	156.1	37	81%

Source: Morgan Stanley Research estimates

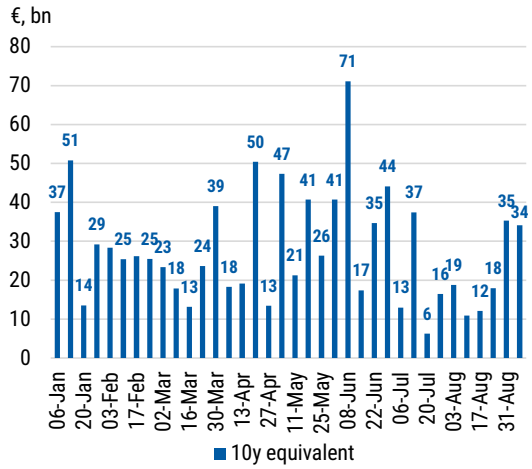
Primary market activity picked up from August lows, with syndications from Italy, Germany, and Greece contributing to the issuance volumes. However, the weekly numbers remain below the April-June peak, especially in outright terms. The first two weeks of September also saw over €50bn of redemptions from Italy and Germany. With the average weekly pace of sovereign PSPP/PEPP purchases at €14bn or more (assuming 80% share of purchases), EGB issuance net of QE and redemptions has been negative in September to date.

Exhibit 24: Weekly supply, 11 largest EGB issuers



Source: Morgan Stanley Research estimates

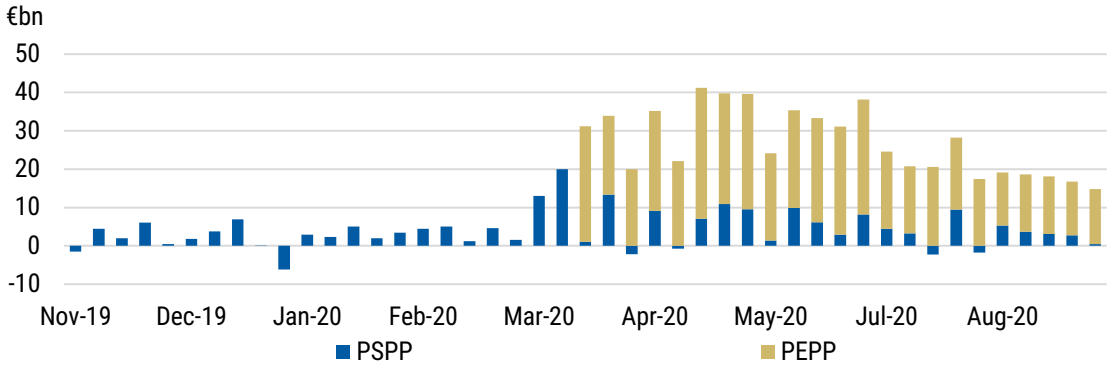
Exhibit 25: Weekly 10y equivalent issuance in 2020



Source: Morgan Stanley Research estimates

We expect this negative net supply dynamic to persist into the end of the year as the pace of ECB purchases picks up over the next few weeks and countries likely require less funding given some degree of faster-than-expected economic improvement. We see the most likely revisions to our 2020 gross issuance projections as being to the downside.

Exhibit 26: Weekly PSPP/PEPP purchases



Source: ECB, Haver Analytics, Morgan Stanley Research

Japanese Investors Sellers of Bunds, Buyers of BTPs in July

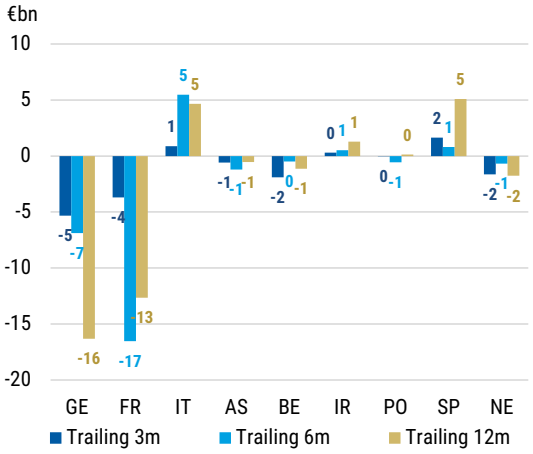
According to data released by Japan's Ministry of Finance, the aggregate Japanese investors' net purchases of EGBs for the nine countries we track were slightly negative in July, consistent with the modest net selling pattern observed since March 2020.

Highlights from the monthly data were the following:

- **Germany saw the largest net outflows of €5.4bn in July**, followed by the Netherlands (-€1.3bn) and Spain (-€0.2bn). This was the highest level of activity seen this year, bringing 2020 YTD net selling of bunds to €7bn, second only to OATs, which saw €14.1bn of outflows. **The largest inflows in July and YTD were in Italy**, at €2.8bn and €5.7bn, respectively. OAT purchases were flat in July.
- **On a rolling 3m basis, Japanese investors remain net sellers of EGB**s, with Spain seeing the most substantial net buying activity (€1.6bn). Ireland and Italy also saw positive flows, while PGBs are close to flat.
- **On a rolling 12m basis, flows into Bunds (-€16bn) and OATs (-€13bn) remain notably negative** while periphery issuers saw the largest inflows, with Spain and Italy both close to €5bn.
- **On an FX-hedged basis** the most attractive yield pick-ups for Japanese investors vs a 10y JGB remain in Italy, Portugal, and Spain, with Ireland now the most attractive in the semi-core space. France and Belgium both offer a marginal yield pick-up on an FX-hedged basis, but it remains very low relative to past years.

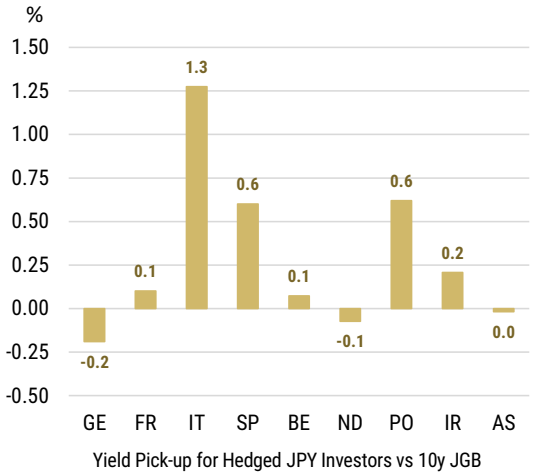
In our view, the most interesting stories from these data are the selling of OATs and Bunds in 2020, likely in part due to the less attractive yield levels relative to 2019 and the steady purchases of BTPs.

Exhibit 27: Japanese investor purchases - Trailing 3m, 6m, and 12m flows



Source: Japan MoF, Haver Analytics, Bloomberg, Morgan Stanley Research

Exhibit 28: Current FX-hedged yield pick-up for Japanese investors vs 10y JGB



Source: Bloomberg, Haver Analytics, Morgan Stanley Research

Trade idea: Maintain Long 10y BTPs vs Short 10y German Bunds

Trade idea: Maintain Long 10y Netherlands vs Short 10y German Bunds

United Kingdom | Heightened uncertainty vs supply

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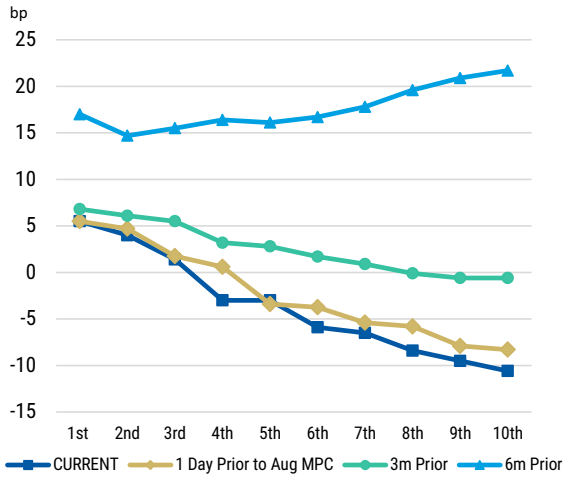
Heightened uncertainty vs supply

Bottom line: The higher probability of a hard Brexit that our economists now foresee (see Brexit: It's Back) joins an already growing list of unanswered autumn uncertainties in the UK such as the expiration of the furlough scheme, talk of possible tax increases, the timing and content of the autumn budget, upcoming issuance needs and the outlook for additional COVID-19 measures. With answers to many of these uncertainties perhaps still weeks and months away, gilts once again appear susceptible to persistent headline risk for the last few months of the year.

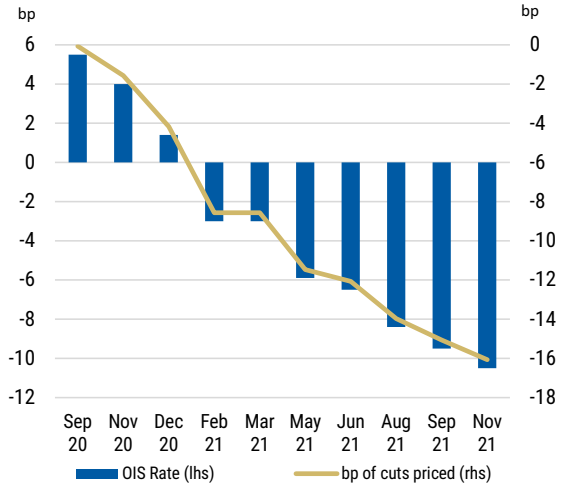
For markets, this increase in Brexit uncertainty has led to a repricing of MPC rate cut probabilities, with a move to negative Bank Rate now priced in to a greater extent than even prior to the August MPC meeting. In our view, there was already a belief within the market that the MPC's forecasts could turn out to be overly optimistic, even prior to the increase in Brexit uncertainty. Recent developments may be adding to that concern and reinforcing our economists' call for additional MPC easing. However, as the market reassesses its probability of a harder Brexit outcome in combination with other uncertainties, one of the only certainties in the UK gilt market at this current juncture will continue to be a steady dose of positive net supply post BoE purchases between now and the end of November. We see both of these forces as likely to assert themselves at varying times in the coming months.

Exhibit 29: UK MPC OIS levels, current and prior to August MPC meeting



Source: Bloomberg, Morgan Stanley Research

Exhibit 30: UK MPC OIS level (lhs) and basis points of cuts priced (rhs)



Source: Bloomberg, Morgan Stanley Research

We continue to like cross-market 30y gilt shorts versus longs in 30y Bunds and/or expressions that look for greater steepening pressure in the UKT 10s30s curve relative to the DBR 10s30s curve. We move away from UKT 2s5s steepeners, given the strong correlation between the 2s5s curve and deep inversions in longer-maturity MPC OIS versus Sonia.

Avoid UKT 2s5s steepeners: Recent history would suggest that the UKT 2s5s curve could move back inverted if the market starts to price a more aggressive MPC cut probability into longer-dated MPC OIS. Specifically, we have looked at the relationship between 10th MPC - Sonia and the UKT 2s5s curve and found a very strong correlation between them in the last couple of years.

In other words, it's not uncommon to see periods of deeper UKT 2s5s inversion when a near-term Bank Rate cut is somewhat in question but a cut over the medium term seems fairly likely. The lone exception was the period post the MPC's emergency package of easing measures in March 2020, when the 2y adjusted more aggressively than any other part of the curve.

We think that the change in Brexit probabilities combined with other uncertainties will keep the market more comfortable about pricing a negative Bank Rate in the future, suggesting to us that the risk/reward for holding UKT 2s5s steepeners may be less compelling.

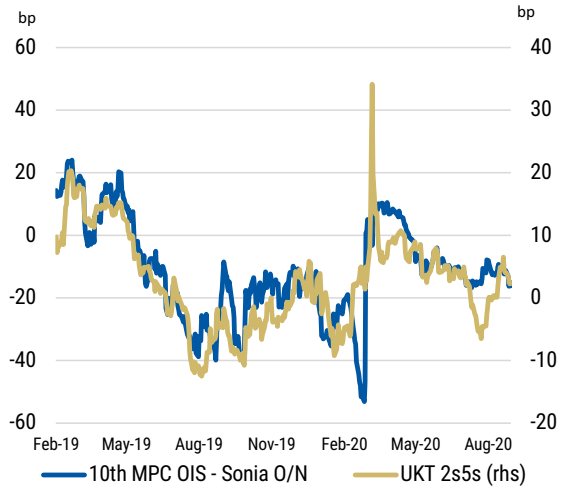
The two scenarios that would change this assessment would be either clarity about the sources of uncertainty that are perceived to be growth-positive by the market and/or a view that the MPC could choose to move aggressively into negative rates rather than limp in, perhaps resulting in a similar steepening in the UKT 2s5s similar to March 2020. However, both these potential outcomes still seem some time away so we move away from UKT 2s5s steepeners.

Staying in cross-market gilt shorts: We continue to like cross-market 30y gilt shorts versus longs in 30y Bunds and/or expressions that look for greater steepening pressure in the UKT 10s30s curve relative to the DBR 10s30s curve. Relative supply dynamics continue to suggest that there will be notable net supply post BoE purchases in the long bucket, particularly during the month of October (see Gilt Cross-Market Shorts vs Bunds or UKT 10s30s Steepeners? August 14, 2020).

However, at the same time, we see far fewer reasons why core euro area 10s30s curves will steepen to the same extent. In fact, we think there is a chance that core euro area 10s30s curves flatten into year-end, particularly if inflation continues to disappoint and the euro rallies enough to lead markets to speculate about an increase in the PEPP or some additional ECB measures. Additionally, we look for the ECB to absorb all or a substantial portion of any long-end supply that may be issued in the coming weeks and months out to 30 years and 364 days to maturity.

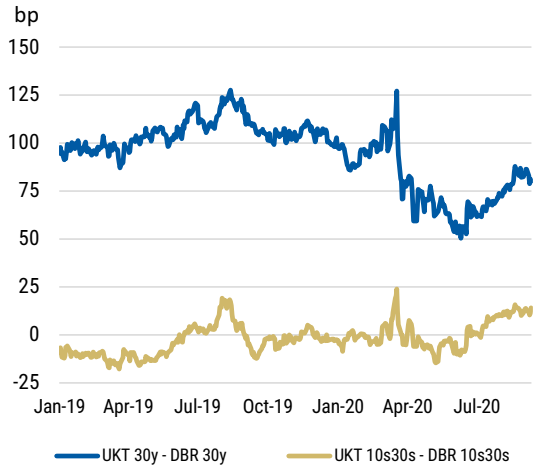
Finally, we anticipate a lower WAM of EU SURE issuance, given the maximum average maturity of 15 years for loans and some precedent from the EFSM of issuing shorter to drive down borrowing costs to fund longer-maturity installments (see EU SURE Details Emerging, August 25, 2020). We see the biggest risk to both these views as a broad-based deterioration in risk sentiment that sees the market reach for yield more aggressively, but the long-end supply in the UK post BoE purchases may continue to act as somewhat of a deterrent.

Exhibit 31: UKT 2s5s curve versus 10th MPC minus Sonia spread



Source: Bloomberg, Morgan Stanley Research

Exhibit 32: UK 30y - German 30y and UK 10s30s - German 10s30s



Source: Bloomberg, Morgan Stanley Research

Watching Irish spread versus semi-core and Bunds: One theme that we will continue to monitor in the coming weeks is the performance of Irish bonds relative to both German Bunds and the broader semi-core, including but not limited to Belgium, France and Austria. In previous periods of heightened Brexit uncertainty, Irish spreads have tended to widen relative to these markets, although the spread to Bunds has tended to also be sensitive to the broader periphery environment during these times.

Shortly after the increase in Brexit uncertainty earlier this week, there did appear to be some evidence that Irish spreads did start to underperform relative to the semi-core, in line with past precedent. However, so far the move has been modest. We will continue to monitor Irish spread performance both for possible Brexit hedges and spread-tightening opportunities, given our relatively favourable medium-term view of Ireland's economic and fiscal outlook.

10y Gilt Future Performance Following a Weaker Summer

Summer months tend to be pretty favorable for UK Gilt, German Bund and US Treasury duration. In fact, we think this is probably one of the most understood seasonal patterns in the market. However, there have been some instances when summer months have had negative returns on a 10y future in the past and it just so happens that the summer of 2020 turned out to be one of them.

Currently, the UK Gilt market finds itself in the rarest of the three possible outcomes we looked at coming out of the summer months; one whereby the 10y Gilt future had a negative return in August and the overall July/August performance was also negative.

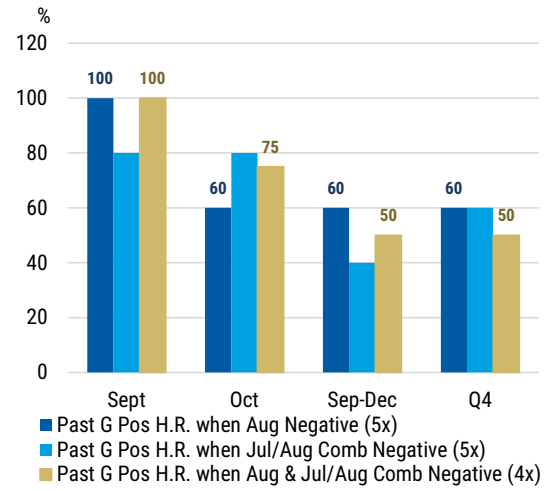
In fact, since the early 1990s there have only been 4 times prior to 2020 when a 10y Gilt future had met this condition and only 5 times each when the 10y Gilt future has had a negative return in either August or July/August combined (Exhibit 34).

We took a look back at when the return for a 10y Gilt future was either negative in August, negative in July/August combined or negative in both instances. We found the following from our study. Results were also similar for both 10y German Bund futures and 10y US Treasury futures (reminder that past performance is not a guarantee of future performance):

- The month of September had a positive return in 100% of instances after the 10y Gilt future had either a negative August return or a combined July/August negative return. Both of those conditions apply today. September 2020 will count as a positive month if the current on-the-run 10y Gilt future (G Z0) closes above 135.01.
- However, returns for the remainder of the year were more mixed suggesting that some of the rebound typically seen in September in 10y Gilt futures after a softer summer had at least reversed to some extent in the past in Q4.
- For example, when the August return was negative and July/August combined was also negative in the past, the 10y Gilt future had a positive return in Q4 only 50% of the time. For the 10y US Treasury future the return was positive only 40% of the time and 33% of the time for the 10y German Bund future.

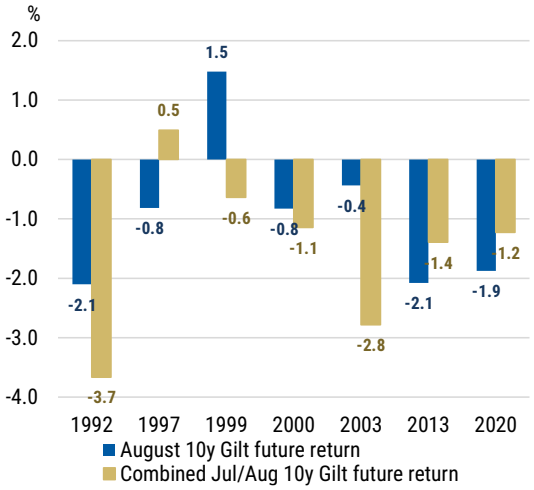
Importantly, these studies are limited by a fairly small number of observations given how rare summer duration weakness tends to be but we think it important to understand how markets have evolved in the periods after outlier events. If history is a guide, the studies would suggest that investors looking to set short duration positions should wait until Q4. We sympathize with this view. We maintain our Q3 10y Gilt forecast at 20bp.

Exhibit 33: Hit Ratio For Positive 10y Gilt Future Return After a Negative Return in August, July/August Combined or both



Source: Morgan Stanley Research, Bloomberg, past performance does not guarantee future performance

Exhibit 34: Periods When 10y Gilt Future Return was Negative in August or July/August Combined



Source: Morgan Stanley Research, Bloomberg, past performance does not guarantee future performance

Trade idea: Maintain Short 30y UKT vs Long 30y DBR

Japan | Heavy long-end supply is over

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Favorable external environment in duration

The JGB market has remained quiet even as participants have returned from their summer vacations. Prime Minister Shinzo Abe's resignation for health reasons did of course come as a surprise, but Chief Cabinet Secretary Yoshihide Suga, a front runner in the LDP leadership election, has signaled his intention to stick with the current administration's policies if he were to win the election (see this). More importantly for the JGB market, BoJ Deputy Governor Masazumi Wakatabe indicated in a recent press conference that "Regardless of who succeeds Abe, we believe our monetary policy is on the right track, and appropriate for the current situation" (NHK). Market participants appear to share this view, which may help to explain why Abe's resignation has yet to trigger any especially noteworthy price action.

Attention thus looks likely to remain focused primarily on global developments and supply/demand events for at least the time being. With regard to the former, the next FOMC meeting is scheduled for September 15–16, and market participants are also waiting for some sort of progress on the US fiscal policy front. The current market consensus appears to be that enactment of the necessary legislation will be difficult before the November 3 presidential election in the absence of any meaningful developments so far.

With regard to US monetary policy, the Fed launched its new +2% "average inflation targeting framework" at last month's Jackson Hole Economic Policy Symposium, but subsequent communications by Fed officials might have disappointed market participants by making no mention of QE guidelines or a possible reinforcement of forward guidance. We attribute the US stock market's recent softness in the face of seemingly positive data to (1) a dialing back of hopes for additional Fed support to more realistic levels and (2) a decline in the perceived probability of Congress approving a fiscal stimulus package in the near future. Our overall impression is that global sentiment has been shifting towards the "risk off" direction of late.

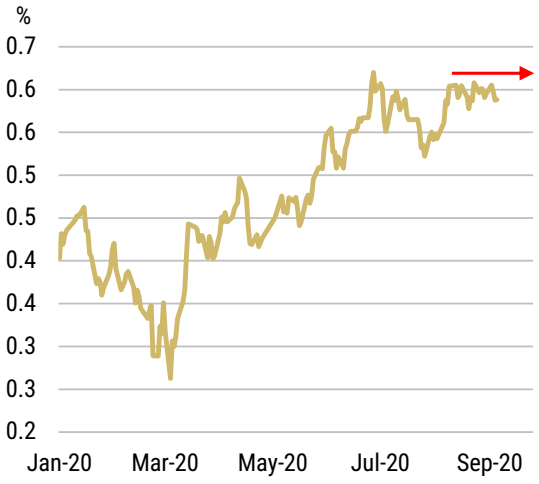
Favorable supply/demand in duration

What about supply/demand events? Concerns that the recent flood of super-long JGB issuance might trigger a significant steepening of the yield curve ultimately proved unfounded, with the 30y yield having basically just held steady over the past month or so (see Exhibit 1). Two 30y auctions were held within the space of just two weeks, but while the auction results themselves were on the weak side, subsequent dip-buying interest in the secondary market was sufficient to support quick rebounds.

A particularly noticeable "auction anomaly" has been seen for the 30y sector so far in 2020 (see Exhibit 36). Market participants still appear anxious about the supply/demand balance given that the MoF is issuing ¥900 billion in new 30y JGBs each month while the BoJ is providing little in the way of support via its bond-buying operations, which likely helps to explain why we have witnessed a repeating cycle whereby the 30y sector corrects pre-auction and yields then return to previous levels on the back of dip-buying demand among life insurers and other real money investors.

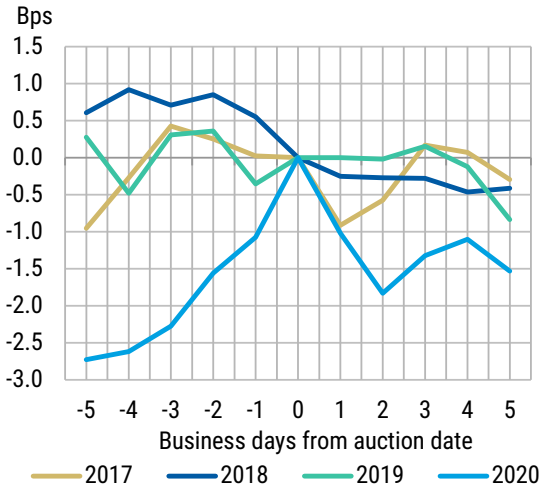
Not only have markets now shifted into "risk off" mode as alluded to above, but we are also set to see somewhat of a break in the supply schedule, with no further issuance of new super-long JGBs slated until the 40y auction on September 24. Our basic expectation is thus that the super-long sector will have little difficulty holding its own through at least the end of the month, and that the JGB yield curve is, if anything, most likely to exhibit a bull-flattening bias.

Exhibit 35: 30y JGB yield history



Source: Japan Mof, Morgan Stanley Research

Exhibit 36: 30y year yield changes around 30y auction



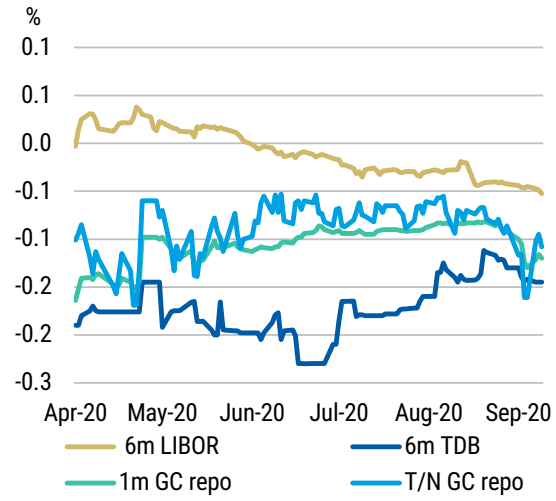
Source: Japan Mof, Morgan Stanley Research

Why has the short end richened?

The short end of the JGB yield curve has richened markedly so far this month, with T-bill yields, repo rates, and LIBOR fixings all participating in the rally (see Exhibit 37). One might ordinarily suspect foreigners of being the primary "culprits", but foreigners have actually been net sellers of TDBs (after including redemptions) over the period in question according to the latest Mof data, suggesting that recent richening should not necessarily be considered indicative of stronger investor demand.

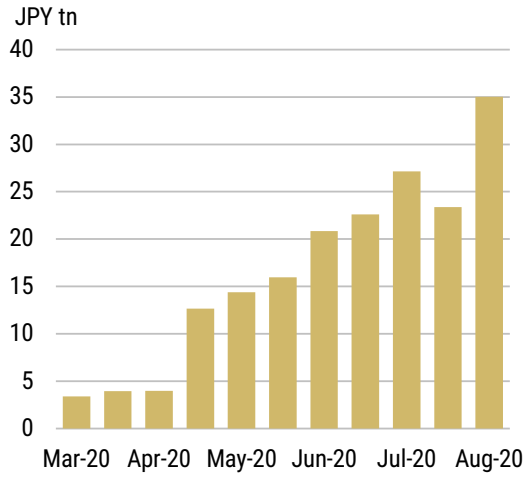
Our hypothesis is that collateral-related demand is likely to have been a contributing factor, with substantial amounts having been borrowed via the BoJ's end-August COVID-19 special operation (see Exhibit 38).

Exhibit 37: Short-end JPY rates



Source: Morgan Stanley Research, Bloomberg

Exhibit 38: Total usage amount of special funds-supplying operations to facilitate financing in response to COVID-19



Source: BoJ, Morgan Stanley Research

As of the end of last month the BoJ had seen a significant decline in its holdings of JGBs and TDBs as collateral and an offsetting increase in its holdings of housing loan receivables and corporate bonds etc (see Exhibit 39). Regional banks with large mortgage portfolios are likely to have been the main furnishers of the latter, with other banks probably still favoring TDBs and JGBs for their ease of use as pooled collateral. Such demand is likely to have created a temporary supply squeeze for TDBs and shorter-dated JGBs, thereby crowding out foreigners into repos and other similar instruments.

LIBOR fixings based on the Level 3 (Expert Judgement) Waterfall Methodology basically appear to be following money market movements in the absence of significant fluctuations in FX swaps. If LIBOR fixings have indeed been pulled lower by declines in short-end interest rates, then richness could potentially start to be corrected once collateral-related demand drops away to more "normal" levels. With the frequency of the BoJ's COVID-19 special operations reportedly set to be reduced from twice to once per month, our basic expectation is that collateral-related demand will no longer be enough to prevent the short end from gradually cheapening due to the impact of substantial hikes in issuance levels.

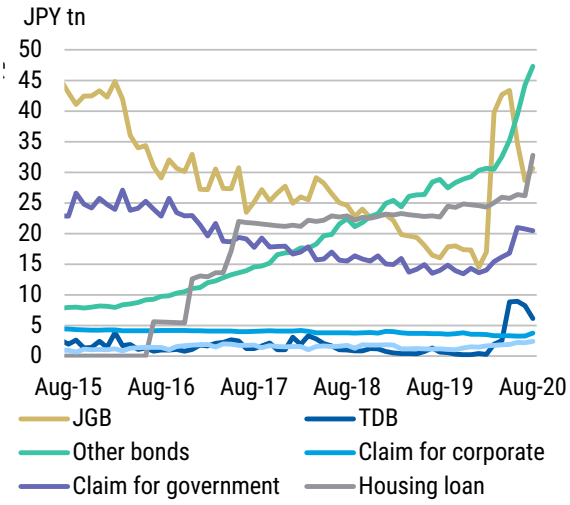
Suggested Positioning

We expect supply/demand conditions to improve in the super-long sector now that the recent issuance rush is behind us and global markets have shifted into "risk off" mode, and therefore suggest exiting 7s30s steepeners for at least the time being. We still like 5s20s flatteners as a core position, but suggest switching the short leg from the already cheap 5y JGBs to the rich 2y swap.

We suggest long 20y JGBs vs paying 2y swaps (which have richened of late in line with the aforementioned decline in LIBOR fixings) . Our main scenario is for LIBOR fixings to start gradually rising once again as supply/demand slackens at the short end due to a waning of collateral-related needs.

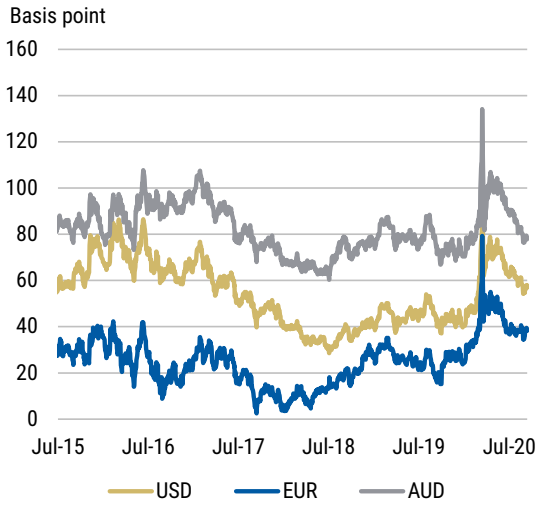
What about previously our recommended AUD-denominated 10y JGB ASW long positions? AUD denominated JGBs continue to offer good yield pickup vs Aussie government bonds, but risk/reward no longer looks all that appealing now that pre-pandemic levels have basically been regained (see Exhibit 40). We therefore suggest exiting at this juncture. We recommend USD-denominated 10y JGB ASW longs by way of a replacement, with history suggesting that there should still be relatively good upside remaining. Potential threats to this trade might include a resurgence of global credit risk concerns and/or a widening of super-long cross-currency basis swap spreads due to (say) an increase in demand for USD funding among Japanese financial institutions.

Exhibit 39: BoJ eligible collateral amount



Source: BoJ, Morgan Stanley Research

Exhibit 40: 10y foreign currency denominated JGBs



Source: Morgan Stanley Research, Bloomberg

Trade idea: Close JGB 7s30s steepener
Trade idea: Shift JGB 5s20s flattener to Pay 2y swap vs long 20y JGBs
Trade idea: Maintain JPY swap 20s30s flattener
Trade idea: Close long 10y AUD denominated JGB ASW
Trade idea: Enter long 10y USD denominated JGB ASW

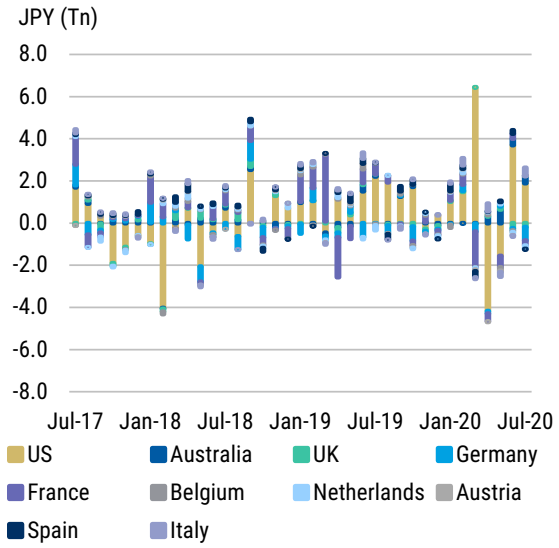
Pension funds more prominent than insurers

Below is an excerpt from Global Macro Strategy: Asian Lifers Monthly FX Snapshot: September 2020 (10 Sep 2020)

Below we take a look at recent investor behavior as reflected in Ministry of Finance (MoF)/Bank of Japan (BoJ) Balance of Payments statistics for July and MoF International Transactions in Securities data for August (both published on September 8). Trust banks (trust accounts on behalf of pension funds) appear to have taken over at least temporarily as the dominant Japanese presence in the foreign bond market, although life insurance companies have continued to make relatively steady allocations to Australian long-term debt securities (bonds).

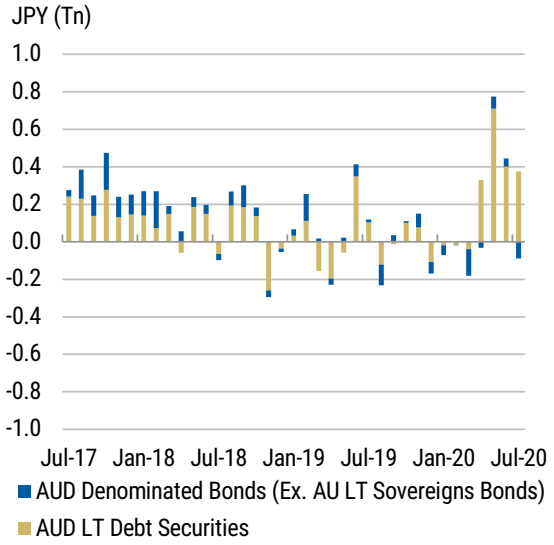
US, Australia and Italy: The Balance of Payments statistics for July show major Japanese investor categories cutting back their net purchases of bonds from June levels, although the US and Australian bond markets did still see net inflows totaling some ¥1.97 trillion and ¥465.3 billion, respectively, while net purchases of Italian bonds hit a record high of ¥372.7 billion (Exhibit 41). Australian bonds are likely to have been purchased mostly by life insurance companies as 'coverage' for their AUD-denominated policy liabilities (Exhibit 42), while US and Italian bonds appear to have been bought up as part of portfolio rebalancing by pension funds, given that trust banks (trust accounts) have accelerated their net purchases over each of the past three months from May through July.

Exhibit 41: Japanese investors' net purchases of foreign long-term debt securities



Source: Ministry of Finance, Bank of Japan, Morgan Stanley Research

Exhibit 42: Japanese investors' net purchases of Australian sovereign bonds versus AUD-denominated bonds ex Australian sovereigns



Source: Ministry of Finance, Bank of Japan, Morgan Stanley Research

As we discussed last month, such developments should come as little surprise. Weekly MoF International Transactions in Securities data for July suggest that Japanese investors made their biggest moves towards the end of the month, when a significant strengthening of the yen triggered an impromptu meeting between MoF, BoJ, and Japan Financial Services Agency (JFSA) officials. Recall that Vice Finance Minister for International Affairs Kenji Okamura told reporters after the meeting that "The government and the Bank of Japan will keep a close watch on underlying market and economic trends and tackle as one as needed," while Finance Minister Taro Aso characterised the yen's rise as "rapid" and declared that "Stability is important, so I'm closely monitoring it with a sense of urgency" (Reuters).

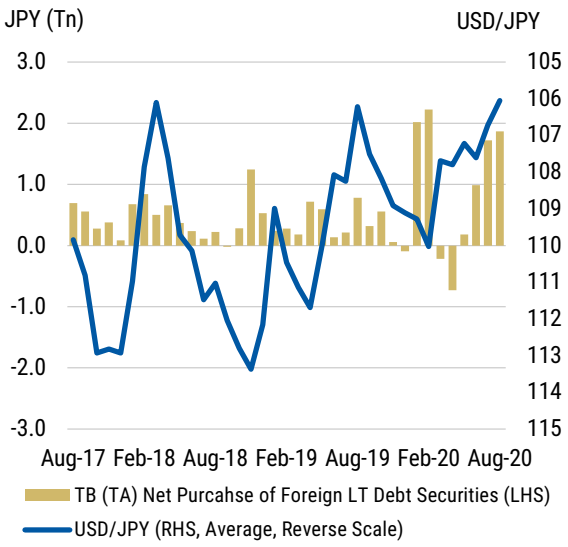
Perhaps not coincidentally, Japanese investors sold off foreign equities to the tune of ¥919.3 billion from July 26 through August 1 while buying up foreign bonds to the tune of ¥1.1 trillion (with the 10y UST yield having dropped from 0.63% to 0.52% over the course of that week). We believe that portfolio rebalancing by the Government Pension Investment Fund (GPIF) is likely to have been the primary driver of these flows, which should have had little if any FX market impact in as much as they constituted a shift out of foreign equities into foreign bonds. We expect that USTs would have been used for rebalancing purposes after the July FOMC meeting proved to be a virtual non-event.

Pensions moving during *Obon* holidays: MoF International Transactions in Securities data for August show major investors cutting back their net purchases of foreign bonds from July, which was likely due at least in part to the inclusion of the *Obon* summer vacation period (August 16-22, based on MoF data).

Trust banks (trust accounts) did remain sizeable net buyers, with their net purchases now having accelerated from ¥0.2 trillion in May to ¥1.0 trillion in June, ¥1.7 trillion in July and ¥1.9 trillion in August, but it seems their buying did not have a significant effect on USD/JPY (Exhibit 43).We believe that portfolio rebalancing remains the primary driver. Weekly data suggest that trust banks (trust accounts) may have been particularly big buyers at the start of the month (August 2-8, based on MoF data), when markets were in 'risk-on' mode as a number of US firms made solid earnings announcements (Exhibit 44).

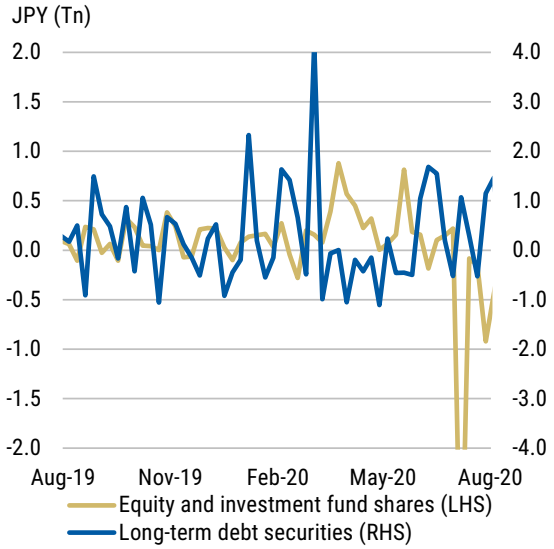
The UST yield curve bear-steepened after the Treasury's August 3 quarterly refunding announcement showed a greater-than-expected reliance on longer-dated bond issuance, and Japanese pension funds may have viewed this temporary weakness as a good buying opportunity. Trading volumes did indeed decline during the *Obon* vacation week, but the market otherwise generally appeared more active than in July.

Exhibit 43: Japanese trust bank (trust account) net purchases of foreign long-term debt securities and USD/JPY



Source: Ministry of Finance, Bank of Japan, Bloomberg, Morgan Stanley Research

Exhibit 44: Japanese investors' weekly international transactions in securities



Source: Ministry of Finance, Bank of Japan, Morgan Stanley Research

Net flows were not especially sizeable in August for either banks (banking accounts) or life insurance companies. Banks (banking accounts) may have once again taken some modest profits after having bought up foreign bonds to the tune of ¥2.5 trillion back in June, while life insurance companies sold slightly more than they bought in both July and August (-¥65.1 billion) following steady net purchases over the course of the April-June quarter.

Dollar bloc | Updating our forecasts

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Along with our US rates colleagues, we use this opportunity to update our forecasts for sovereign rates in Canada, Australia, and New Zealand. Our update base case and bull/base/bear case can be found in Exhibit 45 & Exhibit 46.

Broadly speaking, our framework for interest rates in the three countries remains the same - the key drivers remain central bank policy actions, fiscal policy, and the path for US interest rates given the high correlation of dollar bloc rates to the US Treasury curve (particularly in the longer end).

Exhibit 45: Old and new Morgan Stanley sovereign forecasts in Canada, Australia, and New Zealand

	2Y					5Y					10Y					30Y				
	4Q20	1Q21	2Q21	3Q21	4Q21	4Q20	1Q21	2Q21	3Q21	4Q21	4Q20	1Q21	2Q21	3Q21	4Q21	4Q20	1Q21	2Q21	3Q21	4Q21
Canada (Old)	0.20	0.20	0.20	0.25	0.30	0.50	0.55	0.60	0.65	0.70	0.80	0.85	0.85	0.90	1.00	1.45	1.50	1.55	1.60	1.65
Australia (Old)	0.25	0.25	0.25	0.25	0.25	0.45	0.50	0.50	0.50	0.55	1.05	1.10	1.10	1.15	1.20	1.95	2.10	2.10	2.15	2.20
New Zealand (Old)	0.25	0.25	0.25	0.25	0.25	0.45	0.50	0.55	0.60	0.60	1.00	1.05	1.10	1.15	1.20					
Canada (New)	0.25	0.25	0.25	0.25	0.30	0.40	0.45	0.50	0.55	0.60	0.75	0.80	0.95	1.00	1.05	1.25	1.30	1.50	1.55	1.60
Australia (New)	0.25	0.25	0.25	0.25	0.25	0.40	0.40	0.45	0.45	0.50	1.00	1.00	1.05	1.05	1.10	1.95	2.00	2.05	2.10	2.15
New Zealand (New)	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.05	0.10	0.50	0.40	0.40	0.45	0.50					

Source: Morgan Stanley Research forecasts

Canada: In Canada we expect the front end of the curve to remain anchored to policy expectations. Swaps are pricing in modest increases in the BoC policy rate over the coming years and we expect this risk to remain priced in for some time. As we enter 2021 and pull forward through the year, the market will likely price in a slightly greater path of normalization particularly toward the five year point as our base case for a continued V-shaped recovery both in Canada and globally continues to take hold.

Long end yields should continue drifting higher in line with US yields. A key watchpoint for us in 2021 though is how the BoC deals with its asset purchase program. Given the BoC's articulated framework, we think the market may begin to price a greater and greater chance that the BoC tapers its GoC purchase program (currently C$5bn in bonds per week) as economic data continue to improve within the 'recuperation' phase. The timing of such shift in pricing will likely determine the speed with which long end yields rise.

Australia: Like in Canada, we think the Australian front end will be relatively stable over the coming months, anchored by the RBA's 3y yield curve control target of 25bp. Long end yields have also been relatively stable in the wake of the RBA's program despite the RBA having almost entirely pulled back from asset purchases.

We see scope for long end yields to drift higher alongside global peer yields, though we think the increases will fail to keep pace with those in the US as Australian yields offer attractive risk-adjusted carry. In a world of low yields and dovish central banks, we think Australia's high interest rates will be attractive to foreign investors. Foreign demand, coupled with the RBA potentially stepping in periodically to check an unwarranted rise in rates, should keep any increases in the long end of the ACGB curve more muted, leading to a relative outperformance.

New Zealand: The largest change in our forecasts relates to the front end, which has rallied considerably over the past few months as markets have priced in a considerable risk of negative rates in 2021. We think market pricing of negative rates is likely to continue barring a significant shift in RBNZ rhetoric. As a result, we think the front end likely stays at current levels for the foreseeable future.

We continue to see scope for long end yields to fall further as the RBNZ absorbs a larger and larger share of the government bond market - 60% by 2022, based on our current estimates. We think the trend of the RBNZ front loading purchases may continue as the RBNZ's 'least regrets' approach to easing suggests it will want to have as much of a positive impact as it can earlier on.

Exhibit 46: Old and new Morgan Stanley sovereign 10-year yield bull, base, and bear case forecasts

	Bull						Base						Bear					
	3Q20	4Q20	1Q21	2Q21	3Q21	4Q21	3Q20	4Q20	1Q21	2Q21	3Q21	4Q21	3Q20	4Q20	1Q21	2Q21	3Q21	4Q21
US	0.75	0.55	0.45	0.40	0.40	0.40	0.75	0.95	0.95	1.00	1.05	1.20	1.35	1.50	1.55	1.65	1.65	1.80
Germany	-0.60	-0.70	-0.75	-0.75	-0.85	-0.85	-0.30	-0.10	-0.05	0.05	0.10	0.15	0.00	0.15	0.25	0.35	0.50	0.60
Japan	-0.05	-0.05	-0.10	-0.05	-0.05	-0.05	0.00	0.00	-0.05	0.00	0.00	0.00	0.05	0.05	0.00	0.05	0.10	0.15
UK	0.05	0.00	-0.05	-0.10	-0.10	-0.15	0.20	0.25	0.35	0.45	0.50	0.60	0.40	0.50	0.60	0.75	0.90	1.00
Canada	0.40	0.35	0.35	0.35	0.35	0.35	0.70	0.80	0.85	0.85	0.90	1.00	0.75	0.90	0.95	1.05	1.15	1.20
Australia	0.70	0.60	1.45	0.50	0.40	0.40	1.00	1.05	1.10	1.10	1.15	1.20	1.10	1.30	0.45	1.30	1.60	1.65
New Zealand	0.60	0.50	0.45	0.40	0.40	0.40	0.95	1.00	1.05	1.10	1.15	1.20	1.10	1.20	1.25	1.30	1.35	1.40
Austria*	10	5	0	0	0	0	20	15	10	5	5	5	45	55	60	65	70	75
Netherlands*	5	0	-5	-5	-5	-5	15	10	5	0	0	0	35	40	45	50	55	60
France*	15	10	5	0	0	0	25	20	15	15	15	15	60	75	85	90	95	100
Belgium*	20	15	10	5	5	5	30	25	20	20	20	20	75	85	95	100	105	110
Ireland*	20	15	10	5	0	0	35	30	25	20	15	15	80	90	100	105	110	115
Spain*	45	35	30	25	20	20	65	55	45	35	30	30	140	175	185	195	205	215
Italy*	100	75	65	55	50	50	145	115	100	90	80	70	250	300	315	330	340	350
Portugal*	35	25	20	15	10	10	60	45	35	30	25	20	150	180	190	200	210	220

Source: Morgan Stanley Research forecasts

We remove our 2s10s Canada steepener recommendation in line with our US rates colleagues' expectation that long-end US yields have limited room to rise. *Ceteris parabis*, we continue to expect substantial Canadian issuance to put upward pressure on long-end Canadian yields as the Canadian Department of Finance lengthens the WAM of its issuance. As a result, we suggest investors maintain Canada swap spread wideners. However, long-end Canadian yields are unlikely to rise meaningfully in the absence of US curve steepening.

Trade idea: Maintain NZ 2s10s flatteners at 61bp
Trade idea: Remain outright long the NZ September 2040 IIB at -11bp
Trade idea: Maintain NZ 10y swap spread tighteners at 20bp
Trade idea: Close Canada 2s10s steepeners at 30bp
Trade idea: Maintain Canada swap spread wideners at -21bp
Trade idea: Maintain limit order to buy the Australia April 2023 ACGB at 30bp
Trade idea: Remain outright long the Australia April 2024 ACGB at 27bp

Currency & Foreign Exchange

The 2020 Institutional Investor (II) Global Fixed-Income Research poll is open. If you enjoy our work, please rate us five stars in the following categories: USA: Economics & Strategy > Currency & Foreign Exchange; Developed Europe: Economics & Strategy > Currency & Foreign Exchange; Japan > Currency & Foreign Exchange; Asia (ex-Japan) > Local Markets FX Strategy. Thanks for your readership and support.

G10

G10 | Covid-19, Mobility and FX

FX markets have become less sensitive to the resurgence in Covid-19 cases over the past few months. The markets' forward-looking nature and expectations for a quicker-than-usual vaccine approval might be part of the reason, but we note that mobility trends across G10 countries have also continued improving despite the rise in cases. Looking across G10, countries that had implemented less strict coronavirus restrictions (like Sweden), as well as those that imposed restrictions relatively earlier on (like Norway and Switzerland) are the ones that are now closer to pre-Covid-19 mobility levels, while the UK and Australia are still showing low mobility levels. While unlikely to be a short-term catalyst for FX moves, changes in mobility might become more important further into the autumn if cases continue to rise and governments decide to reintroduce tighter restrictions: private consumption is an important component of economic activity in G10 and changes in each country's economic trajectory could lead to differentiated approaches on both the monetary and fiscal policy front, something that FX markets would be particularly sensitive to.

United States

USD | FX pairs and booming shares

The negative correlation of the USD to equity markets, particularly the US equity market, is an important and well-known FX market theme. It may seem paradoxical, though, that we also observe that, on the whole when US equities are outperforming global equities, the USD tends to weaken even more.

This week we explore if there are conditions in which this relationship breaks down. Put simply: can US equities outperform foreign equities to such a marked degree that the USD rises instead of falling, as foreign investors shift capital into the US? The results seem to suggest that such a relationship breakdown takes place when US equity returns exceed foreign equity returns at the 90th percentile or above, particularly using y/y returns. The most recent y/y returns in the US equity market versus foreign peers are above the 80th percentile for half of the G10 economies. Our results suggest that, if these US equity returns improve even more into the 90th percentile, USD-bearish investors should closely watch for a potential breakdown in this negative correlation.

EuropeGBP | The Brexit scenariosJust as the markets were watching GBP/USD rally rapidly to 1.35, another Brexit headline hit. This is the reality – the year-end deadline is nearing and the UK and EU views on key issues are still far apart. We have just published an in-depth article outlining the Brexit scenarios, in which our economists raised their probability of no deal to 40%. We expect GBP to trade sideways but volatile between now and end-October. There may be points when markets suddenly become optimistic and times when markets suddenly become pessimistic. The market is neutrally positioned GBP at the moment, while implied volatility is low compared to previous periods of increased Brexit uncertainty. A deal could see GBP/USD rally to 1.40, while no-deal could see a fallback to 1.15. EUR/GBP will likely move in line with the GBP leg but with lower volatility.

SEK | What next?
We see EUR/SEK trading sideways for now, as EUR/USD is likely to remain in a range, keeping any downside pressure on EUR/SEK modest. In the coming months, however, EUR/SEK is likely to correct higher toward 10.70 as the positive catalysts for risk market support start to fade and our economists expect Swedish data to start slowing, which could increase Riksbank easing expectations. With our economists raising the probability of a no-deal Brexit to 40% and GBP likely to trade in a volatile manner, we no longer suggest long GBP/SEK.

Dollar Bloc
In line with our tactically neutral USD view, we remain neutral on AUD/USD, USD/CAD, and NZD/USD. AUD/USD remains chiefly driven by the USD and risk sentiment, though we maintain focus on domestic factors as well – the continued lockdown in Victoria, the pace of fiscal spending going forward, and the RBA's reaction function to both weaker domestic data and currency strength. We remain structurally bearish on NZD, although we consider it more attractive to sell on crosses such as AUD/NZD (targeting 1.12 with a stop of 1.0550). NZD/CAD remains in a technical downtrend as well. Short-term investors remain focused on the prospect for negative rates in New Zealand though we continue to view the more meaningful long-term driver of NZD weakness as the prospect for foreigners to sell their NZGB holdings as the RBNZ continues to increase its asset holdings.

CAD | A balanced outlook CAD | A balanced outlook We expect CAD to be primarily driven by the fiscal outlook in both the US and Canada and the potential for investor caution ahead of the US election. We are monitoring the two countries' relative success in containing COVID-19 and stances of central bank policy, but we don't expect those factors to play primary roles in near-term CAD movements. The prospect for fiscal expansion in Canada raises near-term downside risks for USD/CAD, but we expect investor caution over the course of the US election to limit any USD/CAD gains. USD/CAD has moved to around where long-term changes in US-Canadian yield differentials would suggest the pair should trade, further limiting downside potential for USD/CAD.

USD | FX pairs and booming shares

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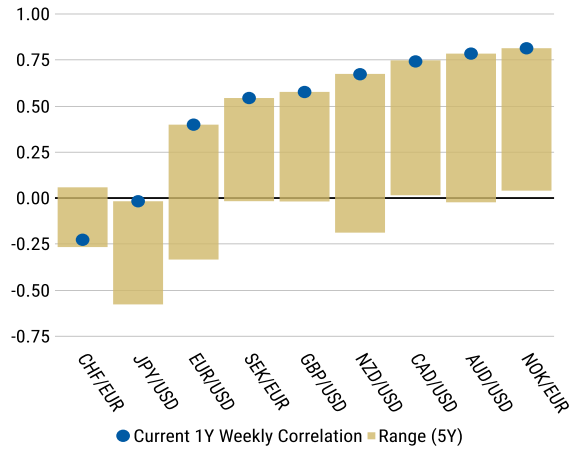
FX investor focus on the equity markets has increased in recent months, along with the correlation of USD pairs to equities themselves. Indeed the correlation of many FX pairs, both USD- and non-USD crosses, currently have historically high correlations to the US equity market (Exhibit 47).

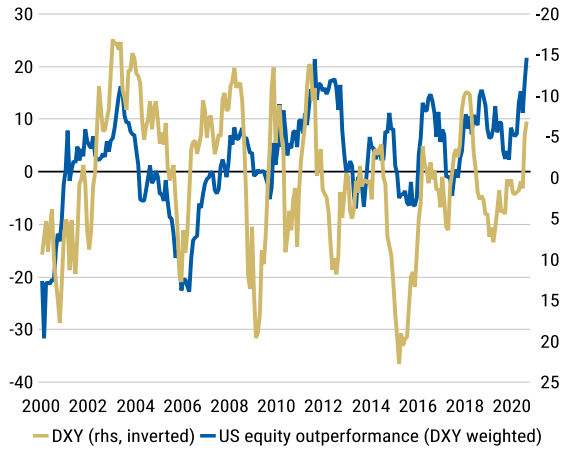
Interestingly, though, this relationship is not just present in US equities in isolation. We also observe a (modest) relationship between the USD and the relative outperformance of US equities versus local equity markets (Exhibit 48). Perhaps paradoxically, though, the relationship is negative. That is, the more US equities are outperforming the rest of the world, the weaker the USD gets.

Exhibit 47: The correlation of FX to US equities is historically high



Source: Macrobond, Morgan Stanley Research

Exhibit 48: USD tends to weaken when US equities are outperforming global peers



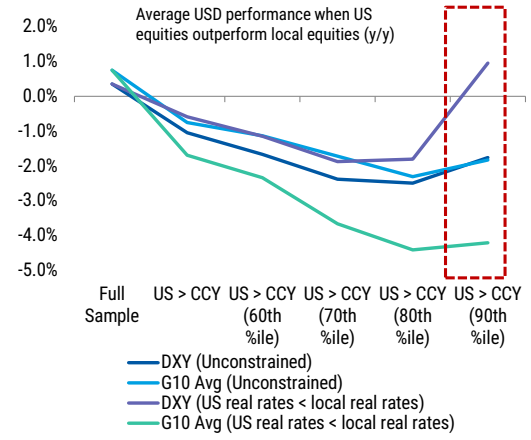
Source: Macrobond, Morgan Stanley Research

Why? This likely reflects the USD's past and likely continued behavior as both a safe haven and a funding currency. Rising US equities even if relative to others likely takes place in a macro environment of elevated risk sentiment – and thus rising capital demand and focus on investment in higher-risk but perhaps higher-yielding markets. Thus, even though in periods when the US equity market might appear to be a better and better place for foreigners to invest their capital, these potential inflows into US assets are likely outweighed by liability outflows.

One question remains, though – is this always the case? Could there be scenarios where US equity outperformance is *so* substantial that this relationship breaks down? Could we observe scenarios where, even though US fixed income returns (e.g., real yields) are relatively unattractive, the "pull" of US equity returns is so compelling as to outweigh the "push" of low fixed income returns? Indeed our colleagues have found some evidence to suggest that, once one vol adjusts relative performance, stronger local markets tend to be a good forward-looking indicator of returns.

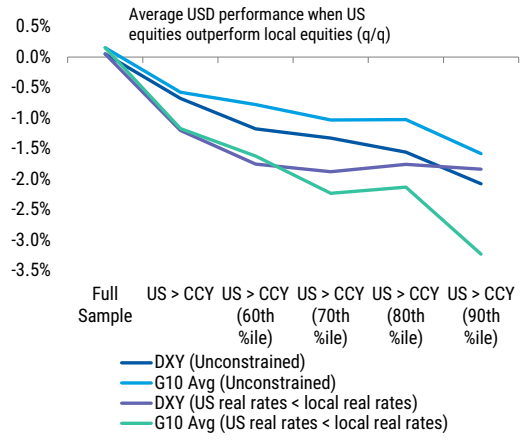
To examine this question, we look at how the USD performs conditioned on various scenarios: when US equities are outperforming foreign equities, but then also conditioned on US equity outperformance reaching a critical threshold. That is, not just when US equities are outperforming, but also when they are at least in the 60th, 70th, 80th, and 90th percentile of performance. This method should potentially capture a "kink" in the curve where outperformance is so substantial to break the trend.

Exhibit 49: USD weakness begins to reverse when US equity outperformance of local equities exceeds the 90th percentile (y/y)



Source: Macrobond, Morgan Stanley Research

Exhibit 50: Using q/q data though the USD's relationship with US equity outperformance is more consistently negative



Source: Macrobond, Morgan Stanley Research

We look at the monthly data using both y/y and q/q returns, and also condition the results on US real yields falling relative to foreign real yields to try to capture whether US equity outperformance could "overpower" the reduced attractiveness of US real fixed income returns.

Our results suggest that this "kink" in the curve exists around the 90th percentile. The results for the DXY and the G10 average can be found in Exhibit 49 & Exhibit 50 for data using y/y returns and q/q returns, both unconstrained and conditioned on US real yields falling more than local real yields.

As one might expect based on the above, USD weakness tends to be more substantial and more consistent in periods where US equity outperformance is also more substantial. This pattern is evident across our four scenarios – using q/q and y/y data and both unconditioned and conditional on US real yields underperforming foreign real yields.

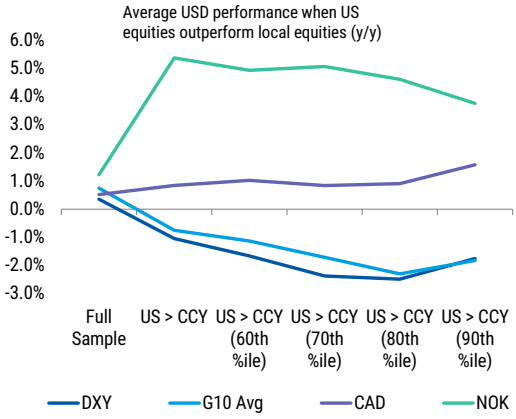
Using y/y data, we find that USD underperformance is less substantial using data from the 90th percentile+ only compared to the 80th percentile+. When we add in the real yields conditioning, in fact, using data of 90th percentile+ equity outperformance we observe the DXY *rising*, though this is chiefly explained by EUR/USD strength in this scenario. Even so, the G10 average is slightly below that of the 80th percentile+ bucket.

Using q/q data, though, the kink is no longer observable. The USD performance in general tended to be more significant when equity outperformance was stronger, though the DXY performance when conditioned on US real rate underperformance was far more muted.

What explains this breakdown? One possible explanation is that scenarios where the y/y return differential is in the 90th percentile or higher is likely one of a significant structural change in economic performance. That is, such a substantive return differential that persists for 12 months is likely to be one that is meaningful and perhaps long-lasting. This could be because US equities are truly outperforming, but perhaps more likely, it is a scenario when local equities are really struggling.

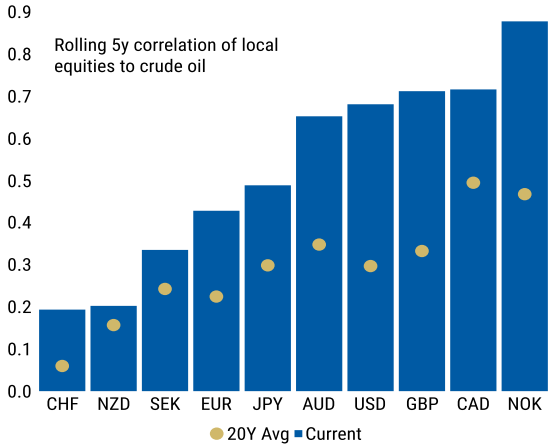
Thus, it makes sense that local currency strength would be more limited in this scenario relative to the USD. By comparison, q/q returns might be more short lived and perhaps reflect fewer structural economic shifts – and thus shorter-term correlations – may be more likely to hold in that scenario.

Exhibit 51: USD/NOK and USD/CAD display a positive relationship to US equity outperformance



Source: Macrobond, Morgan Stanley Research

Exhibit 52: The correlation of Norwegian and Canadian equity markets to oil is relatively high



Source: Macrobond, Morgan Stanley Research

Indeed, one interesting observation that comes out of this analysis is how CAD and NOK perform. Unlike most other currency pairs that seem to show the negative relationship holding across pairs, time horizon, and equity performance conditioning, **USD/NOK and USD/CAD both seem to display a *positive* relationship to equity performance differential**.

What explains this? Likely oil. Here, we think situations where US equities are meaningfully outperforming Norwegian or Canadian equities is likely one in which oil prices have fallen significantly. Both these equity markets have a strong correlation to oil prices. The results are more substantial using the y/y data than using q/q returns, though, which perhaps affirms our thinking that y/y data may be more reflective of larger, more structural, and perhaps longer-lasting economic factors, to which investors with long time horizons (and large AUMs) may be more responsive.

One final point we emphasize is that the sample size for data in the 90th percentile is more limited. This is particularly true when one constrains the sample to months when both US equity outperformance exceeded the 90th percentile and US real yields fell relative to local real yields. In some cases the number of observations here were under 10. Thus, while the data do seem to paint a picture, we caution that a limited sample size should be taken into account.

Conclusion: The results suggest that while the correlation of the USD to equities generally holds, it is not truly universal. When US equity outperformance relative to local equities reaches historically high levels, FX relationships begin to break down. This could be either because US equities are truly outperforming or because local equities are underperforming. Indeed, with the oil currencies we observe that the high correlation of local equities to oil means that the USD could end up gaining despite the S&P 500 performing well because of local factors.

G10 | Covid-19, Mobility and FX

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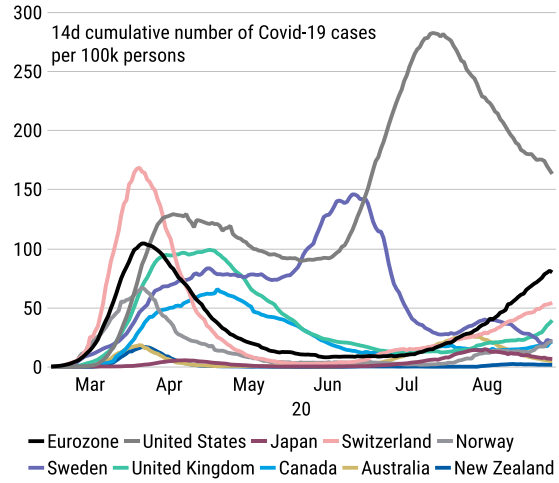
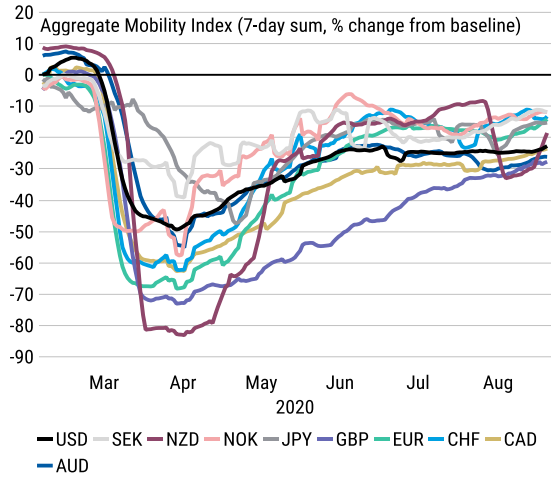
FX and broader risk markets have become less sensitive to the resurgence in Covid-19 cases over the past few months, despite many countries even beginning to experience a second wave of coronavirus infections (Exhibit 53). The markets' forward looking nature and expectations for the release of Phase III vaccine clinical trial results later in the year – increasing the potential for a quicker than usual vaccine approval – could go some way in explaining why the FX market has paid less attention to the recent case dynamics around the world.

Exhibit 53: Cases are continuing to rise in most of G10, with many countries experiencing second waves…



Source: Macrobond, Morgan Stanley Research

Exhibit 54: …but mobility has barely budged this time. Quite the contrary, it has kept on improving

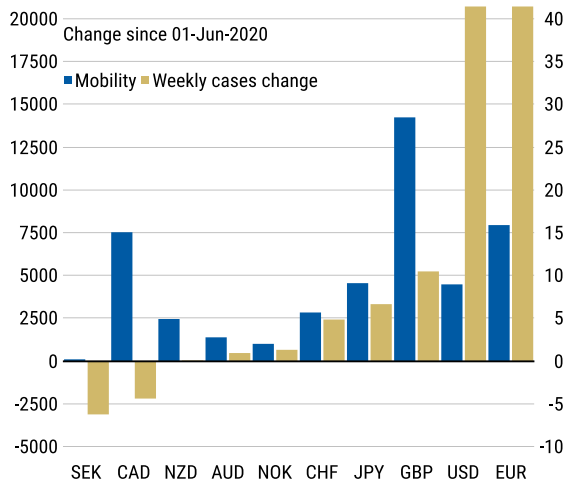


Source: Macrobond, Google LLC "Google COVID-19 Community Mobility Reports", Morgan Stanley Research
Note: Average of mobility changes versus baseline in three categories: retail and recreation, workplaces and public transport. We used 2019 EU19 GDP weights to create the eurozone aggregate index

We offer an alternative perspective, showing that **improving mobility trends across G10 countries have been barely influenced so far despite the resurgence in coronavirus cases** (Exhibit 54). We construct our own mobility index using data from Google's Mobility Reports, but focussing purely on mobility to places that are fundamentally more important to the economy: retail and recreation (restaurants, shopping centres, cinemas etc.), workplaces and public transport (airports, train, bus and metro stations). We construct one index for each country in G10 and use 2019 GDP weights to aggregate the individual EU19 data into one single Eurozone index, thereby putting more emphasis on bigger Eurozone economies.

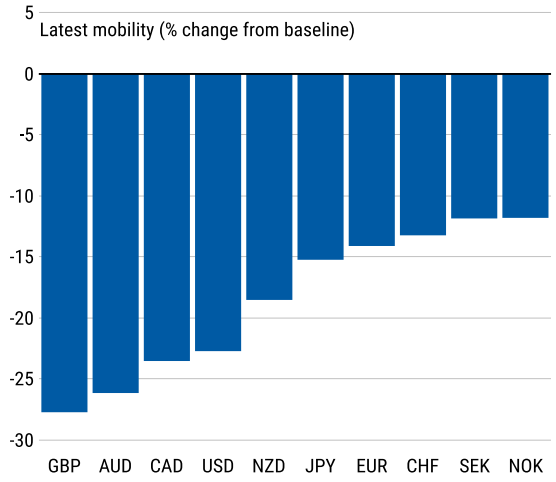
Mobility as seen through this metric is now higher across G10 than it was back in the beginning of June (Exhibit 55), suggesting that the rise in cases has indeed not translated into less economic activity. The gradual lifting of more coronavirus restrictions over summer as well as spending and tourism initiatives designed to kick start the economy (for example the Eat Out to Help Out Scheme in the UK and the Geneva Gift Card in Switzerland) might have played a role in keeping mobility strong during this time.

Exhibit 55: Mobility has improved across all G10 since June, despite the rise in cases



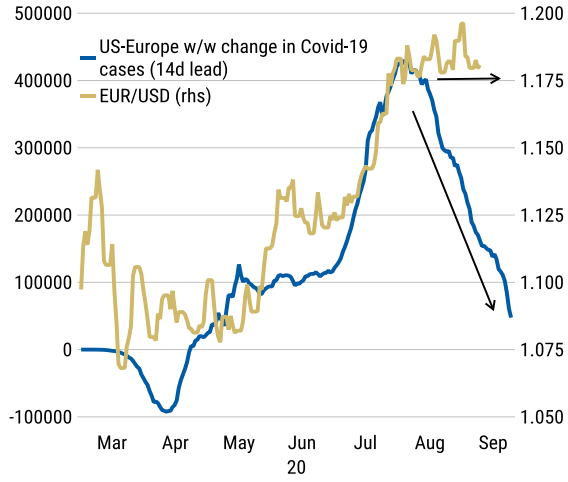
Source: Macrobond, Google LLC "Google COVID-19 Community Mobility Reports", Morgan Stanley Research

Exhibit 56: Mobility has returned most to normal in Norway and Sweden, while in Australia and UK it remains >25% below pre-Covid-19 levels



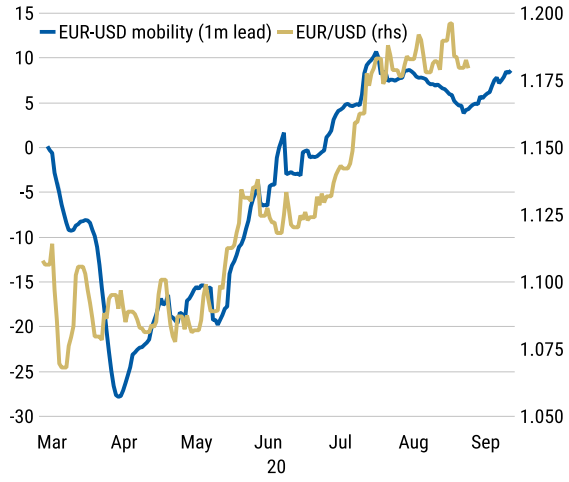
Source: Macrobond, Google LLC "Google COVID-19 Community Mobility Reports", Morgan Stanley Research

Exhibit 57: EUR/USD has deviated from US-Europe cases differential...



Source: Macrobond, Morgan Stanley Research

Exhibit 58: ...but has tracked future expectations of mobility more closely



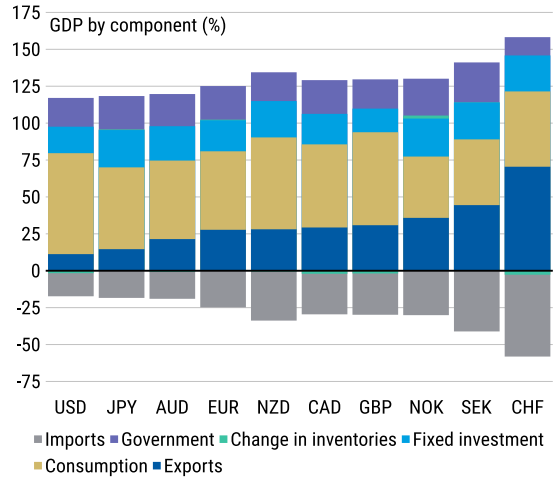
Source: Macrobond, Google LLC "Google COVID-19 Community Mobility Reports", Morgan Stanley Research

Looking across G10 (Exhibit 56), **countries that implemented less strict coronavirus restrictions** (like Sweden), **as well as those that imposed restrictions relatively earlier on** (like Norway and Switzerland) **are the ones that are now closer to pre-Covid-19 levels**. On the other hand, countries like the **UK and Australia are still showing low mobility levels.**

Changes in mobility are unlikely to be a major driver for the FX market in the short term - with risk appetite and broader USD movements instead deemed as bigger drivers. **They could however become increasingly more important further into the autumn**: one way governments could react to the rising number of cases would be by re-imposing some of the previous coronavirus movement and gathering restrictions.

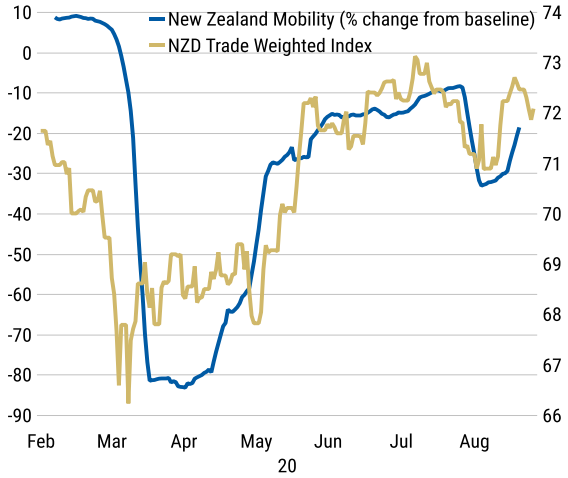
This could lead to more suppressed economic activity, given private consumption accounts for a significant proportion of GDP across G10 economies (Exhibit 59). In turn, this can have implications for each country's economic trajectory and **could lead to differentiated approaches on both the monetary and fiscal policy front, something that FX markets would be particularly sensitive to**.

Exhibit 59: Consumption is an important component of GDP in G10



Source: Macrobond, Morgan Stanley Research

Exhibit 60: New Zealand's trade-weighted exchange rate has tracked changes in mobility



Source: Macrobond, Google LLC "Google COVID-19 Community Mobility Reports", Morgan Stanley Research

Trade idea: Continue to hold 1.0760 EUR/CHF put (expiry mid Jan 2021), receiving 1.39%.

GBP | The Brexit scenarios

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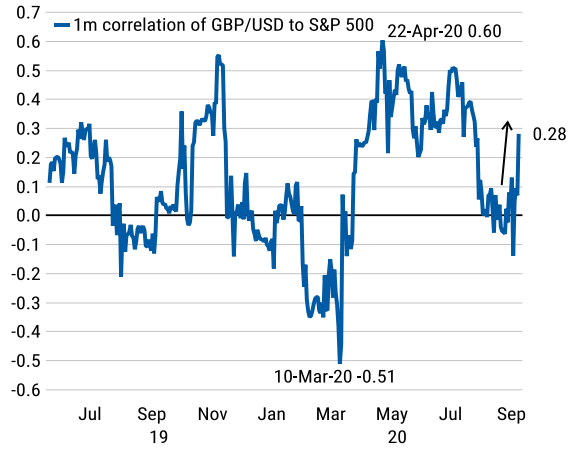
Just as the markets were watching GBP/USD rally rapidly to 1.35, another Brexit headline hit. This is the reality – the year-end deadline is nearing and the UK and EU views on key issues are still far apart. We have just published an in-depth article outlining the Brexit scenarios, where our economists raised the probability of no deal to 40%. We expect GBP to trade sideways but volatile between now and end-October. There may be points at which markets suddenly become optimistic and times when markets suddenly become pessimistic. The market is neutrally positioned GBP at the moment. A deal could see GBP/USD rally up to 1.40, while no-deal could see a fall back down to 1.15.

For more details see: United Kingdom: Brexit: It's Back, September 11, 2020.

What are the drivers of GBP/USD?

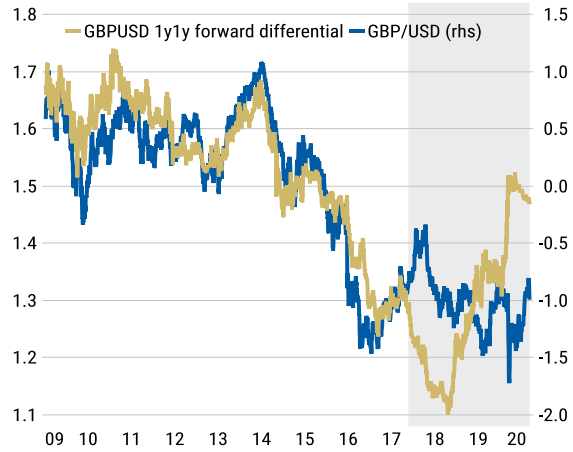
GBP/USD correlation with global risk markets is strong and has picked up again recently (see Exhibit 61), which makes trading GBP on just a UK story difficult. Bank of England (BoE) rates pricing has become less relevant for GBP as the BoE moved away from suggesting that negative rates are on the horizon and also started tapering QE asset purchases. Forward interest rate differentials and shadow short rate differentials both point to GBP/USD being undervalued since 2017. The rapid fall in US rates this year suggests that GBP/USD should be trading closer to 1.50 and not 1.30 (see Exhibit 62).

Exhibit 61: GBP/USD correlation with US equities has risen again



Source: Macrobond, Bloomberg, Morgan Stanley Research

Exhibit 62: Rate differentials still suggest a Brexit discount for GBP/USD



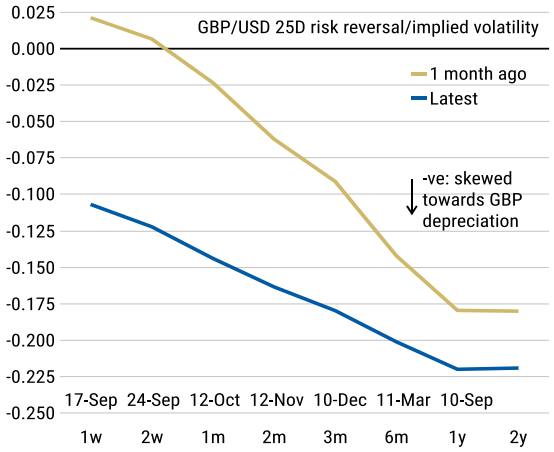
Source: Macrobond, Bloomberg, Morgan Stanley Research

Why does global risk seem to matter more for GBP? We think that this is more a USD dynamic, where USD has become the favored funding currency for carry trades. USD availability is no longer an issue as it was in March when it resulted in GBP/USD falling quickly to 1.15. Now the Fed has eased, USD's inverse correlation with equities appears to have become a market assumption, keeping the correlation strong even for GBP/USD.

What is the market pricing?

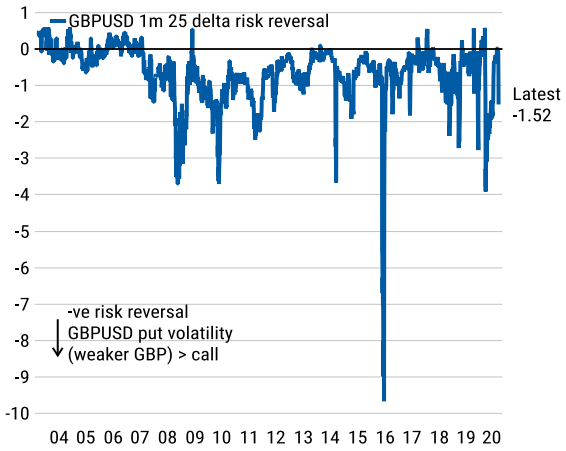
The options market has started to price in GBP/USD uncertainty again, with skew turning more bearish across the curve (see Exhibit 63). However, negative sentiment and pricing aren't as extreme as most Brexit events in the past, as we show in the series of charts below. As GBP/USD was rallying rapidly through 1.30 and to 1.34, GBP/USD 1m options skew turned more bullish GBP. Possibly markets need to use it as a signal that when the 1m GBP/USD 25D risk reversal turns positive, it shows that the market is too optimistic and GBP is more likely to fall soon (see Exhibit 64).

Exhibit 63: GBP/USD options skew is bearish on all tenors, having fallen recently



Source: Macrobond, Bloomberg, Morgan Stanley Research

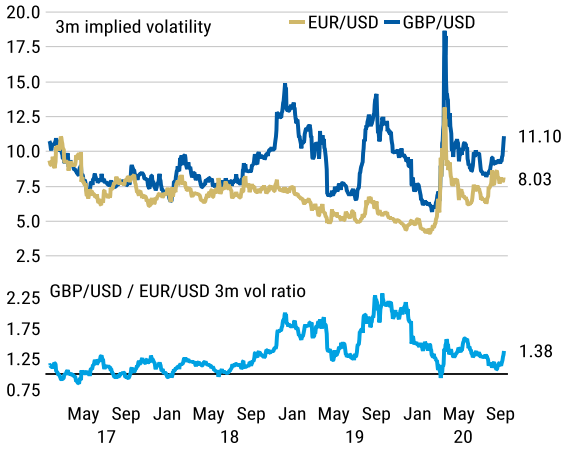
Exhibit 64: It is rare to see 1m GBP/USD skew positive



Source: Macrobond, Bloomberg, Morgan Stanley Research

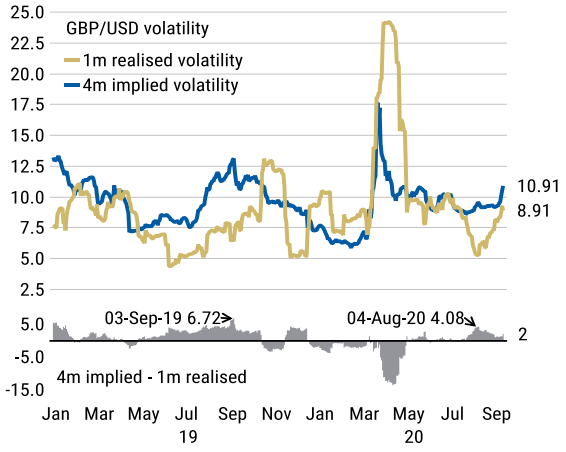
Implied volatility has started to pick up across many G10 currency pairs, as realized spot FX volatility has picked up and because the uncertainty around the US election is starting to be priced into 3-month option tenors. After the recent bout of broader equity and risk volatility in March, actually today GBP/USD implied volatility premium versus EUR/USD is small.

Exhibit 65: GBP implied volatility versus EUR is only slightly elevated



Source: Macrobond, Bloomberg, Morgan Stanley Research

Exhibit 66: GBP options expected volatility over the year-end Brexit deadline isn't extreme



Source: Macrobond, Bloomberg, Morgan Stanley Research

Exhibit 65 shows that GBP implied volatility is around 40% higher than the equivalent for EUR, relative to being over double in August 2019, when the UK parliament was prorogued and Brexit deals were still a concern. The 4m GBP/USD options contract covers the year-end Brexit deadline but implied volatility doesn't appear elevated versus the recent rise in GBP/USD spot realized volatility (see Exhibit 66).

Our analysis suggests that investors wishing to play for either downside GBP risks or upside GBP risks can still experience favorable pricing. For example, Exhibit 67 shows the probability of GBP/USD hitting specific levels over the coming month to year as priced by the options market. As skew is slightly bearish but volatility Is historically low, the probability of reaching even 1.40 in three months' time is considered to be very small. The table shows that there is a 10% probability of GBP/USD trading above 1.39 in three months' time (mid-December), while a similar probability of GBP/USD trading below 1.21.

Exhibit 67: The options market prices a low probability of GBP/USD rallying by mid-December, with only a 10% probability of trading around 1.40

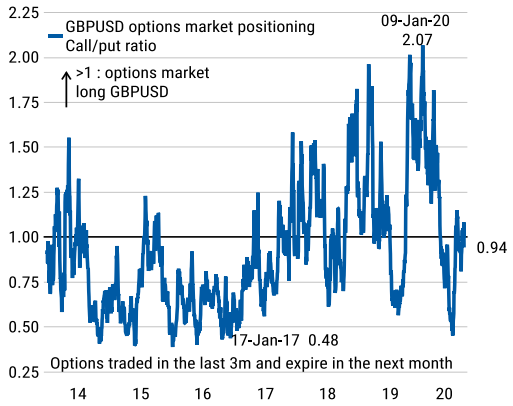
Tenor	Date	Probability of being below or above strike (GBPUSD) 10%	20%	30%	40%	50%	Forward
1m	12-Oct-20	1.25 - 1.35	1.28 - 1.34	1.29 - 1.33	1.30 - 1.32	1.31	1.302
3m	10-Dec-20	1.21 - 1.39	1.25 - 1.36	1.28 - 1.34	1.30 - 1.33	1.31	1.303
6m	11-Mar-21	1.17 - 1.43	1.23 - 1.38	1.27 - 1.36	1.30 - 1.34	1.32	1.304
12m	10-Sep-21	1.11 - 1.47	1.21 - 1.41	1.26 - 1.38	1.30 - 1.35	1.32	1.305

Source: Bloomberg, Morgan Stanley Research

How is the market positioned?

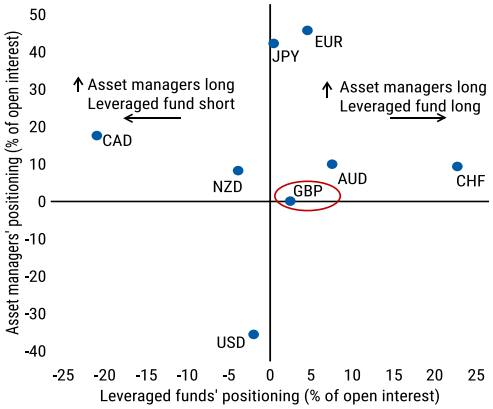
We are often asked how the market is positioned in GBP to assess the balance of risks of a rally or fall. Mostly our assessment in recent years is that the GBP volatility and uncertain political outcomes mean that most investors have stayed away from trading GBP. Short-term speculative positioning has sometimes started to be built, especially via the options market. In July this year, the market was extreme short GBP/USD, the most bearish position within the G10, which was followed by a large short-covering rally.

Exhibit 68: GBP/USD options positioning is neutral after a short-covering rally since July



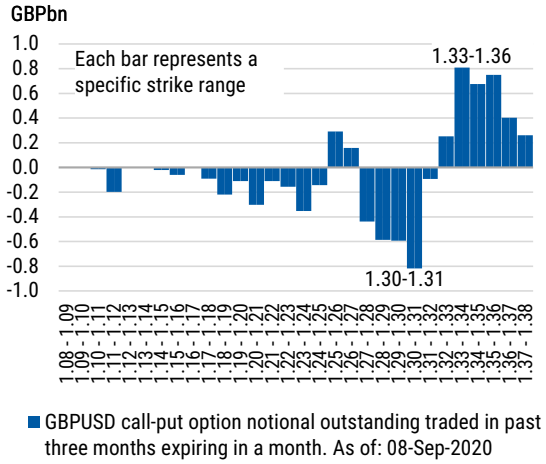
Source: Bloomberg, Morgan Stanley Research

Exhibit 69: Asset managers are neutral GBP while leveraged funds are slightly long



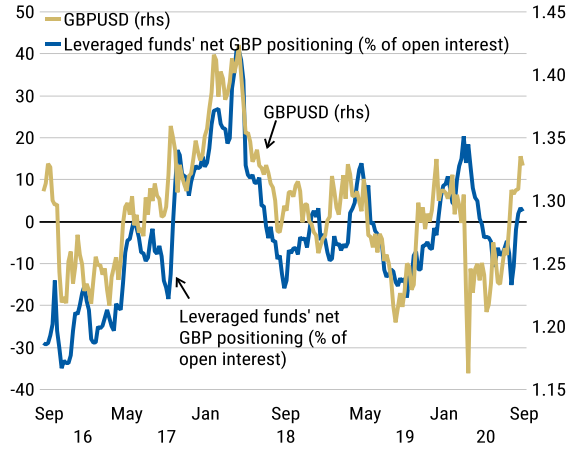
Source: Macrobond, Morgan Stanley Research

Exhibit 70: GBP/USD options market strikes: Net long above 1.33 and short below 1.31


GBPbn
Each bar represents a specific strike range
1.33-1.36
1.30-1.31
GBPUSD call-put option notional outstanding traded in past three months expiring in a month. As of: 08-Sep-2020

Source: Bloomberg, Morgan Stanley Research

Exhibit 71: Leveraged traders turned small long GBP/USD recently via futures


GBPUSD (rhs)
Leveraged funds' net GBP positioning (% of open interest)
GBPUSD (rhs)
Leveraged funds' net GBP positioning (% of open interest)

Source: Macrobond, Morgan Stanley Research

Today we estimate that the market is neutrally positioned in GBP/USD and EUR/GBP (see Exhibit 68). Leveraged funds turned small long GBP recently via futures, while asset managers have remained neutral (see Exhibit 69).

What are the risk events to watch?

The road for GBP is set to be bumpy over the coming months. We focus on the UK events below that may cause GBP to rally or fall depending on the market probabilities assigned to completing a trade deal. The USD side matters too, where markets will focus on equities, Fed commentary and the US election.

September

- UK and EU emergency meeting on Internal Market Bill and related discussions.
- Trade talks – likely to continue but not see much progress. Two sides stay far apart.
- Bilateral talks between UK PM Johnson and Germany's Merkel, France's Macron and Ireland's Martin. GBP could see upside risks should any of the meetings result in moving the talks forward (a criterion Johnson wanted to hit by October 15).
- September 24-25: Special European Council meeting. Not expected to discuss Brexit but it could come on the agenda at the last moment.
- September 28: Round 9 of UK-EU trade talks during that week.

October

- October 3-6: Conservative Party Conference. PM Johnson may wish to use this platform to reinforce that he is willing to walk away from the EU trade talks without a deal.
- October 15: Deadline from PM Johnson saying trade talks had to have progressed.
- October 15-16: EU council meeting, where progress is expected to be made on the trade talks.

November

- November 3: US election: If the result is known a week later and Biden wins then the UK may have a higher incentive to need to push forward in achieving a trade deal with the EU.

December

- Possible rush to negotiate but also prepare businesses for the outcome of no-deal.
- December 10-11: EU council summit.
- December 31: UK leaves the EU.

The Brexit scenarios

The target levels we provide here assume a GBP/USD starting point around 1.30 and a neutrally positioned market. Should the market hear about a deal between the UK and the EU on trade of goods and/or services before the deadline at the end of the year then we would expect GBP/USD to rally towards 1.40 over the coming days and weeks. 1.40 is about halfway between the current level and 1.50 predicted by interest rate differentials. EUR/GBP would fall too but less so as we would expect EUR/USD to rally in the event of a positive Brexit outcome. EUR/GBP could fall to 0.8750.

Should the UK leave the EU at the end of the year without a deal then we would expect GBP/USD to fall towards 1.15 again. The market will likely start to price that in as headlines evolve, so this isn't necessarily a target for year-end under the scenario. We note that the knee-jerk FX reaction will likely be a lower GBP/USD, but we think that it would stabilize or even fall less should the UK have a plan for the period ahead in relation to businesses and international trade. EUR/GBP could rise to 0.97, given that EUR/USD is more elevated today relative to March when EUR/GBP traded a high around 0.9320. With significant market volatility and uncertainty, there is even a chance of EUR/GBP overshooting to 1.00, but our base view is towards 0.97.

GBP/USD falling or rising aggressively on the outcome of this binary event will likely have a spillover impact onto other USD pairs too. We think that most other USD pairs would react due to a movement in equity markets. So, commodity currencies could weaken even if they do not have a large trading relationship with the UK. For more details, see What Is the Best Safe-Haven Currency? August 18, 2020.

We don't differentiate the outcomes between a hard Brexit/WTO rules and a skinny deal (tariff reduction on some products) as the economic impact is similar. However, we think that a skinny deal could be bullish GBP on the headline as the market takes the word 'deal' and becomes positive. We would assume that the GBP rally would be limited and likely faded at that point.

Exhibit 72: Key views for different Brexit scenarios

Scenario	Double deal	Mixed deal	WTO terms
Economist probability	10%	50%	40%
Scenario description	UK out of the single market, but with an agreement on enhanced equivalence in financial services provision in exchange for EU access to UK fishing waters, close alignment on trade in goods	UK out of the single market, limited agreement on cross-border financial services provision, close alignment on trade in goods	UK out of the single market, out of the customs union and with no obligation to align with the EU standards; WTO deal = no mitigating arrangements on tariffs and NTBs; skinny deal = some modest mitigating arrangements on tariffs and NTBs
Economic impact	Modest short-term upside relative to our base case; larger longer-term positive impact relative to both our and BoE estimates of post-Brexit potential growth (1-1.1%Y)	Our base case; 80bp immediate hit to UK GDP over 2021 relative to a counterfactual of maintaining current arrangements	1.1-2.0% of GDP hit in 2021, depending on the scale of mitigating arrangements on tariffs and NTBs, as well as confidence impact on both consumers and businesses
Bank of England response	Rates unchanged at 0.1%; more QE still announced, although the risk is for a smaller package relative to our base case call for another £100bn	Rate cut to 0%; QE top-up of £100bn	QE top-up of a £100bn; rate cut into negative territory – to -25bp in our skinny deal scenario, and to -50bp in a 'pure' WTO scenario
GBP expectation	GBP/USD: 1.45	GBP/USD: 1.40; EUR/GBP: 0.875	GBP/USD: 1.15; EUR/GBP: 0.97
10y gilt expectation	55bp	20bp	-10bp

Source: Morgan Stanley Research forecasts

SEK | What next?

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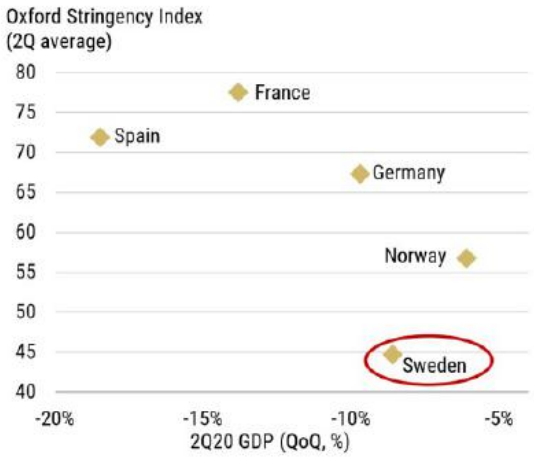
We see EUR/SEK trading sideways for now, as EUR/USD is likely to remain in a range, keeping any downside pressure on EUR/SEK modest. In October/November, however, EUR/SEK is likely to correct higher towards 10.70 as the positive catalysts for risk market support start to fade and our economists expect Swedish data to start slowing, which could increase Riksbank easing expectations. For more details, see Sweden Economics & Global Macro Strategy: What Next for SEK? September 4, 2020.

How is Swedish growth affected by the lighter lockdown approach?

Sharp contraction in 1H20 nonetheless: Despite an easier lockdown, the Swedish economy contracted sharply in 1H20 as consumption and exports were hit by Sweden obeying a lockdown similar to its European neighbors and the global recession. The recovery started in June, but our economists expect the pace of growth to be dampened in 2H20 by rising unemployment.

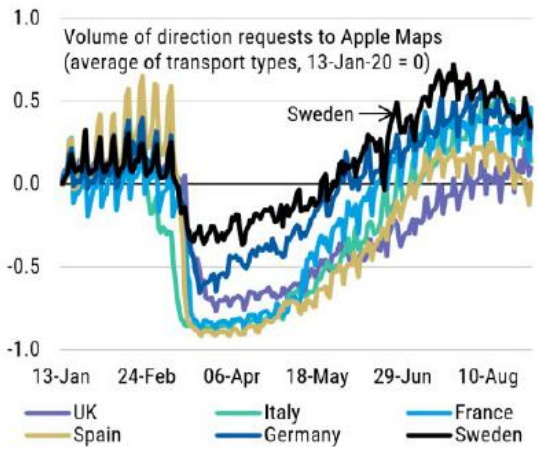
Weak labour market to dampen recovery and trigger rate cut: About 10% of Sweden's labour force is covered under the furlough scheme, which is scheduled to end for some companies at the end of the year (Exhibit 75), and this could push the jobless rate higher. Irrespective of the furlough scheme, though, Sweden's jobless rate has been rising somewhat more markedly compared to the eurozone or UK (Exhibit 76). Our economists see the jobless rate rising and peaking at 11.5% – higher than the Riksbank's 9.5% 2H20 projection – keeping inflation subdued and prompting a rate cut in 1Q21.

Exhibit 73: Easier lockdown meant less of a contraction relative to euro area peers but likely not relative to Norway



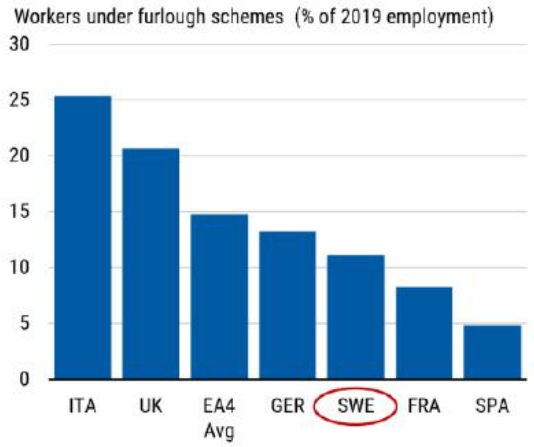
Source: University of Oxford, Haver Analytics, Morgan Stanley Research; Note: Norway = Norges Bank 2Q20 estimate

Exhibit 74: Swedish recovery under way: Mobility indicators back at normal levels



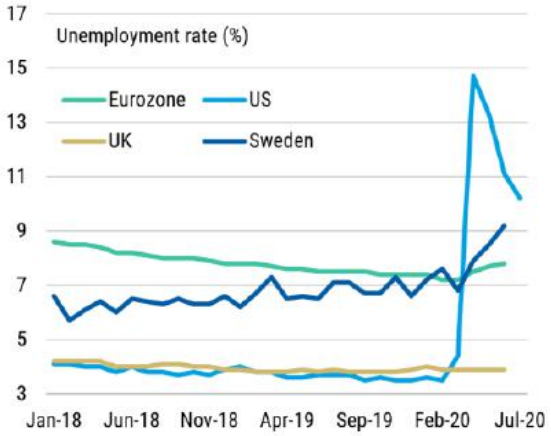
Source: Apple, Morgan Stanley Research

Exhibit 75: Risks ahead: ~10% of Sweden's labour force covered by furlough



Source: Swedish Agency for Economic and Regional Growth, HMRC, national departments of labour, Morgan Stanley Research

Exhibit 76: Sweden's jobless rate already on the rise, regardless of furlough



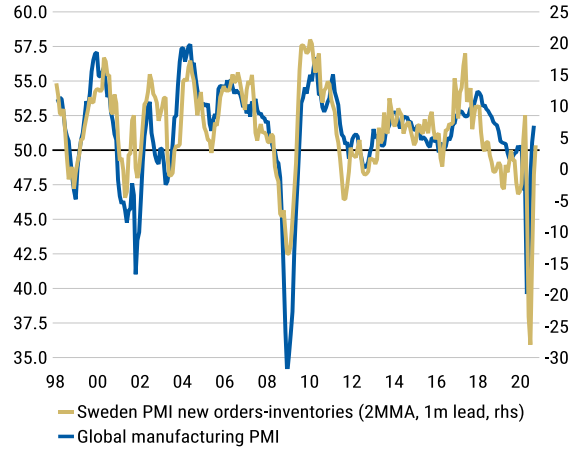
Source: SCB, Eurostat, ONS, BEA, Morgan Stanley Research

Is Sweden a leading indicator for global growth?

Sweden's PMI subcomponents lead global PMI… The new orders - inventories subcomponent of Sweden's manufacturing PMI could be one indicator to look at in combination with other indicators to get a sense of the trajectory of global growth. Looking at the long-run relationship, Sweden's new orders - inventories has tended to lead global manufacturing PMI by one month (Exhibit 77).

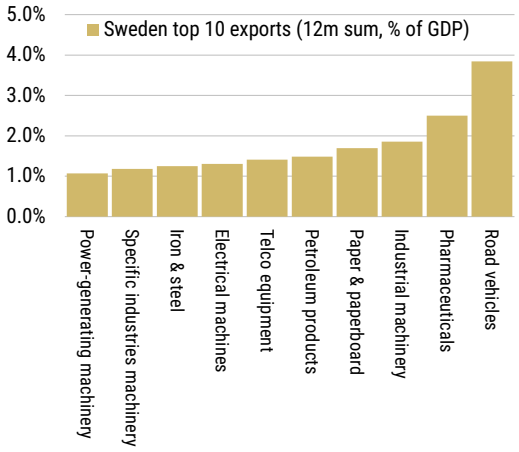
…but should be looked at with other indicators: That said, correlations suggest they are more coincident post-GFC and global new orders - inventories is understandably a better leading indicator for global PMI. This leading relationship of Sweden's new orders - inventories may be due to Sweden's small and open economy and large car and industrial machinery exports (Exhibit 78). Higher demand for these goods may be the first sign of an economic recovery.

Exhibit 77: Sweden's new orders - inventories leads global manufacturing PMI by one month



Source: Haver Analytics, Macrobond, Morgan Stanley Research

Exhibit 78: Sweden exports a lot of cars and industrial machinery

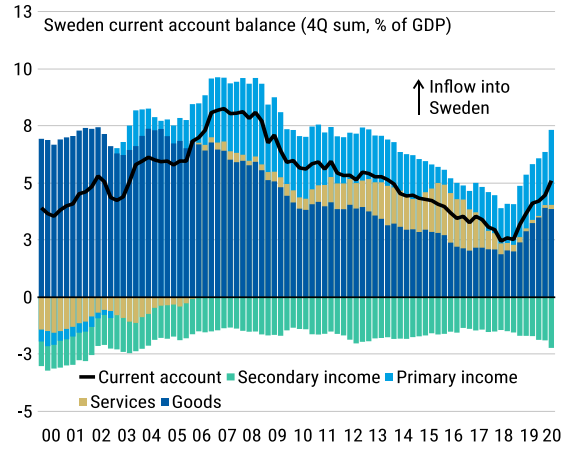


Source: Macrobond, Morgan Stanley Research

SEK: A cyclical or safe-haven currency?

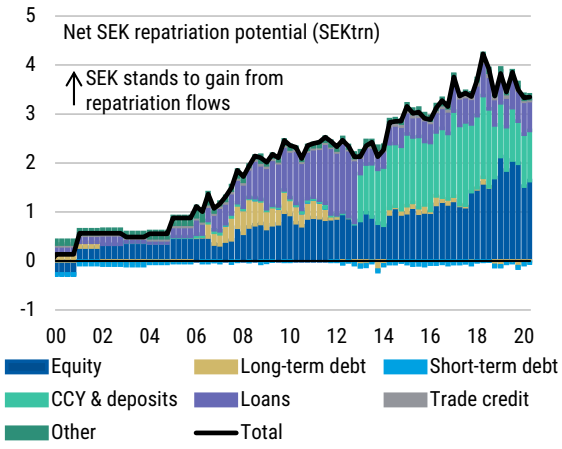
Weaker cyclical currency: SEK has some safe-haven characteristics, e.g., a current account surplus, being used as a funding currency and a net foreign asset position (with Sweden holding more foreign currency-denominated assets abroad than foreigners hold of SEK-denominated assets). However, given Sweden's high exposure to global trade, we expect SEK to continue trading like a cyclical currency, strengthening when global growth and risk do well. The safe-haven features may only help to partly cushion the currency weakness during periods of high global volatility. Ultimately, Riksbank policy may be more important than equities in determining the medium-term SEK trend.

Exhibit 79: Sweden's current account surplus has been growing since 2019



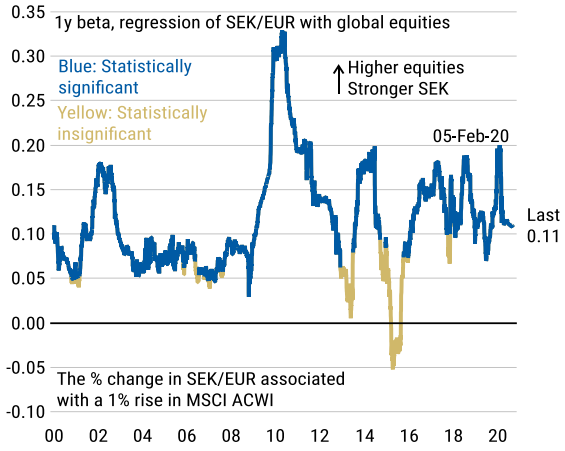
Source: Macrobond, Morgan Stanley Research

Exhibit 80: SEK has the potential to gain from repatriation flows on net



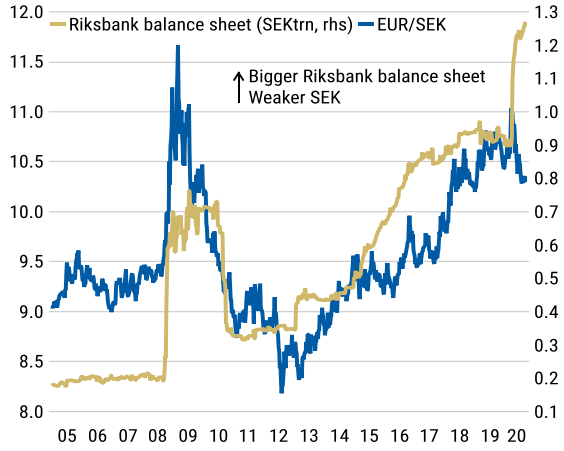
Source: Haver Analytics, Morgan Stanley Research

Exhibit 81: SEK has had a stable and positive relationship with equities over the years…



Source: Bloomberg, Macrobond, Morgan Stanley Research

Exhibit 82: …but Riksbank policy seems more important in determining the medium-term SEK trend



Source: Macrobond, Morgan Stanley Research

Exhibit 83: Recent comments on FX by Riksbank members

Riksbank member	Date	Comments on SEK
Ingves	03-Sep-20	"We, of course, take note of the fact that for once actually the krona has appreciated," but "let me emphasise that for the past months the exchange rate has not been a core issue"
Skingsley	03-Sep-20	"Development in Swedish crown I do not see as particularly dramatic"
	20-Aug-20	"Swedish crown has strengthened quite quickly", "Crown is just one factor among many we take into consideration"
Jansson	09-Sep-20	"Recent rapid strengthening of the krona is currently no major concern", "Krona is an important determining factor for inflation but there are others as well"
	02-Sep-20	"Exchange rate one important factor for inflation outlook"
Flodén	27-Aug-20	"There are no signs that the krona is overvalued despite its recent rally; it has only become less weak"

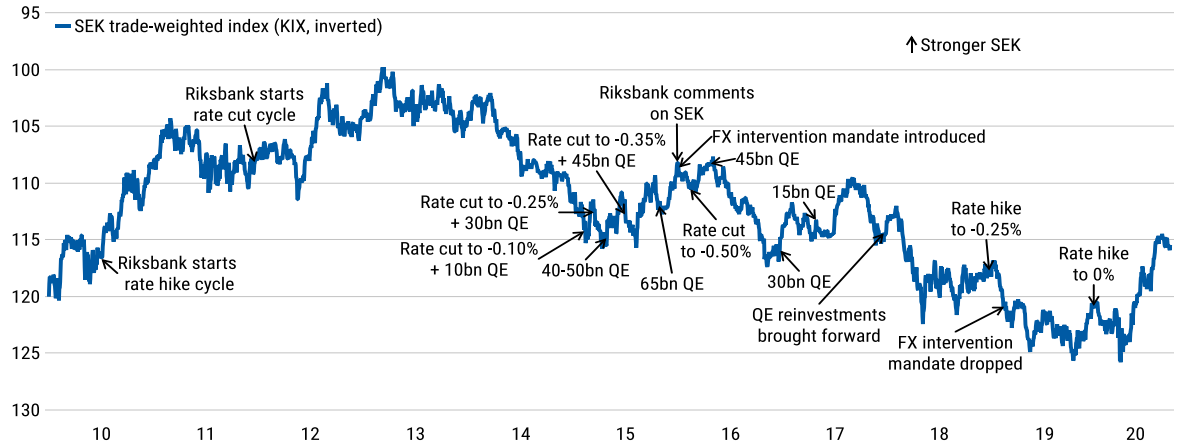
Source: Bloomberg, Morgan Stanley Research

When may the Riksbank start pushing back against FX strength?

SEK not strong enough to worry the Riksbank yet: SEK has seen a rapid rally in recent months but recent Riksbank commentary suggests that the central bank is not worried yet (see Exhibit 83), likely because SEK has not reached a sufficiently strong level. This doesn't mean that the central bank is no longer concerned about SEK strength, though. The Riksbank has explicitly stated that the FX development is one factor which will determine whether it is appropriate to cut the repo rate. Therefore, if SEK rallies too much, too quickly, it is still likely to solicit a response.

9.80-10.00 in EUR/SEK is the key range: We think that if SEK rallies another ~3% quickly, bringing EUR/SEK to the 10 level, the central bank will start to push back verbally. If this is ineffective and EUR/SEK continues weakening rapidly to ~9.80 while inflation expectations start falling, it may trigger Riksbank action, including possibly a repo rate cut.

Exhibit 84: SEK is approaching the zone where the Riksbank has acted in the past, but not there yet

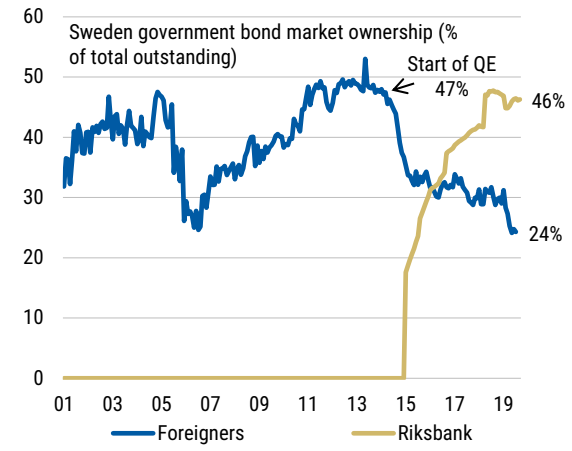


Source: Riksbank, Macrobond, Morgan Stanley Research

Effectiveness of repo rate cut versus QE

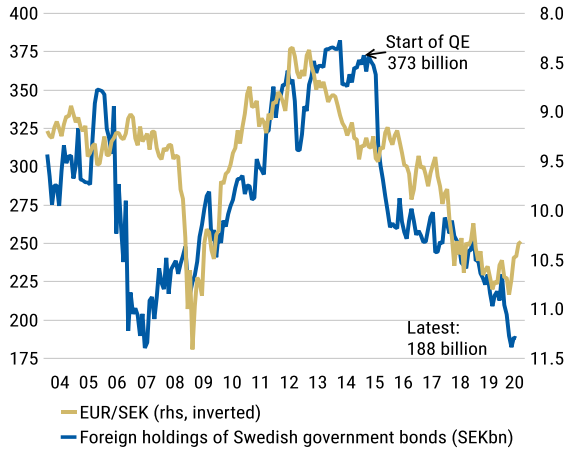
Economic effectiveness: Our economists see a Riksbank repo rate cut as more powerful in boosting inflation expectations and maybe easier to implement during the COVID-19 recovery. QE may not boost aggregate demand significantly unless combined with a fiscal package, as yields are already low and the Riksbank owns a high percentage (46%) of the government bond (SGB) market (see Exhibit 85).

Exhibit 85: Foreigners no longer own as many Swedish government bonds



Source: Macrobond, Morgan Stanley Research

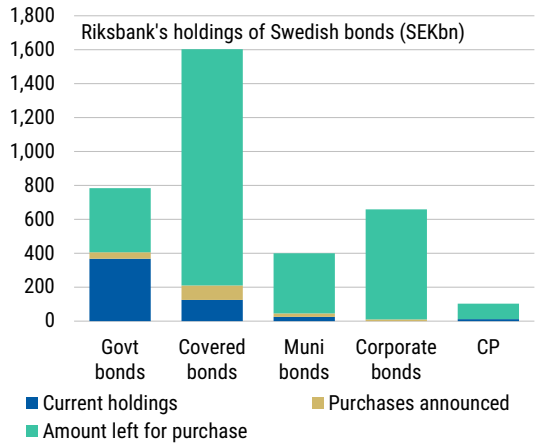
Exhibit 86: SEK weakened as foreigners sold their SGB holdings in the last round of QE



Source: Macrobond, Morgan Stanley Research

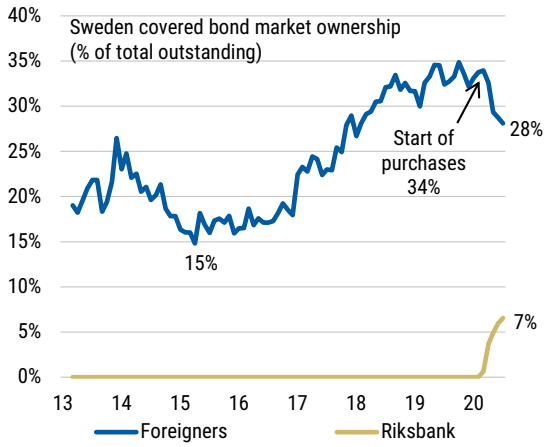
Effectiveness in weakening SEK: While government bond QE may not be able to weaken SEK significantly with foreign ownership in that market at a historical low of 24% (see Exhibit 85), the Riksbank has been focusing on buying covered bonds lately (see Exhibit 87). Here, foreigners still hold a relatively high proportion of the market – 28% compared to the April 2015 low of 15% (see Exhibit 88). Hence, QE can still weaken SEK. However, a repo rate cut would probably have a bigger FX impact as it is not expected by markets. Markets pricing in a full 25bp rate cut may weaken SEK by ~1.5%.

Exhibit 87: The Riksbank's recent purchases have been concentrated in covered bonds



Source: Riksbank, Macrobond, Morgan Stanley Research

Exhibit 88: Foreign ownership of SEK covered bonds still has room to fall



Source: Macrobond, Morgan Stanley Research

Exiting long GBP/SEK

We had previously suggested buying GBP/SEK on dips to 11.48 with a tight stop of 11.30 as a way to play for the idiosyncratic GBP upside potential from a likely Brexit deal that our economists expect. With the swift deterioration in the Brexit news flow in recent days, we have reached the reassessment level on our trade suggestion. Given that our economists now expect a later resolution and have raised their probability of a hard Brexit to 40%, and the road ahead for GBP is likely to be volatile, we no longer suggest long GBP/SEK. We would reconsider the trade only if and when the Brexit news flow improves and a trade deal looks more likely to be struck.

Trade idea: We no longer suggest long GBP/SEK

CAD | A balanced outlook

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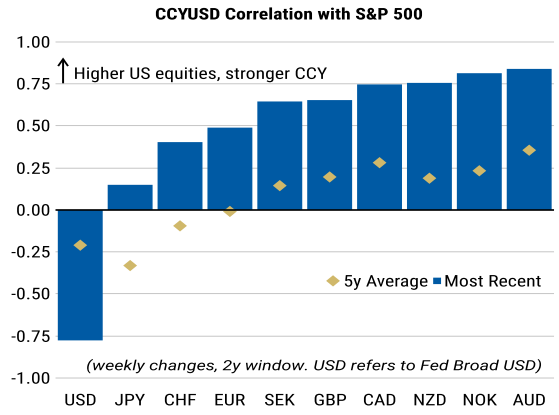
What drove USD/CAD down to 1.31?

The steady decline in USD/CAD from the 1.4000-1.4200 range in 2Q to briefly touch 1.3000 earlier this month was driven by several factors. Like currencies of other commodity-export-dependent economies, CAD has a relatively high beta to global growth and investor sentiment.

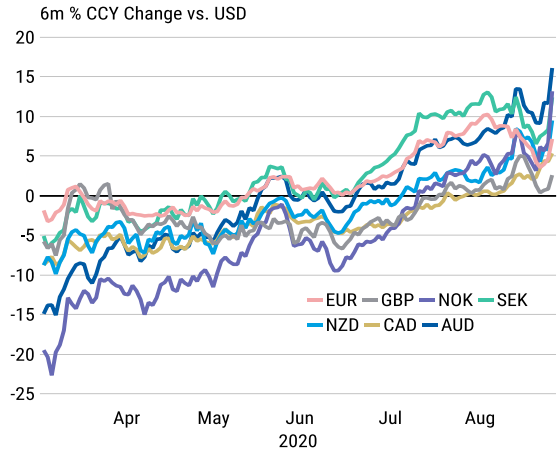
As investors revised upwards their expectations for global growth and corporate earnings, risk assets outperformed and breakevens widened. Increased optimism weighed on the USD broadly, putting downward pressure on USD/CAD. However, CAD has somewhat lagged other G10 currency performance, suggesting that investors remain cautious on Canada-specific drivers.

Exhibit 89: Like other risk-sensitive currencies...



Source: Macrobond, Morgan Stanley Research

Exhibit 90: ...CAD has gained against USD in recent months



Source: Macrobond, Morgan Stanley Research

Where does USD/CAD go from here?

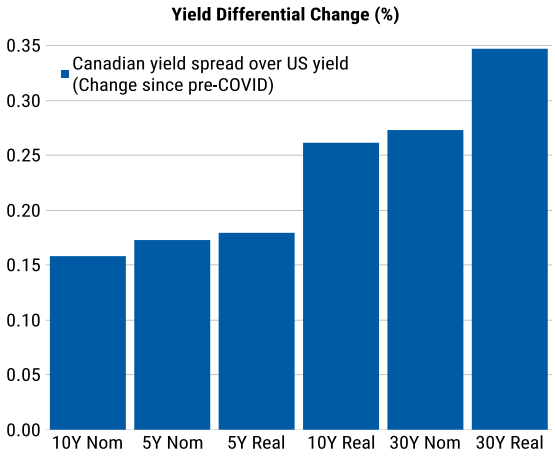
We expect CAD to be primarily driven by the fiscal outlooks in the US and Canada and the potential for investor caution ahead of the US election. We are also monitoring the two countries' relative success in containing COVID-19 and stances of their central bank policies, but we don't expect those factors to play primary roles in near-term CAD movements.

The prospect for robust fiscal expansion in Canada raises near-term downside risks for USD/CAD, but we expect investor caution over the rest of the US election cycle to limit any USD/CAD gains. In addition, USD/CAD has moved to around where long-term changes in US-Canadian yield differentials would suggest the pair should trade, further limiting downside potential for USD/CAD.

Our public policy colleagues continue to expect a deal between congressional Republicans and Democrats to extend fiscal support to the US economy. Fiscal stimulus in the US would raise expectations for US growth, but the resulting boost to risk sentiment would likely send USD broadly lower.

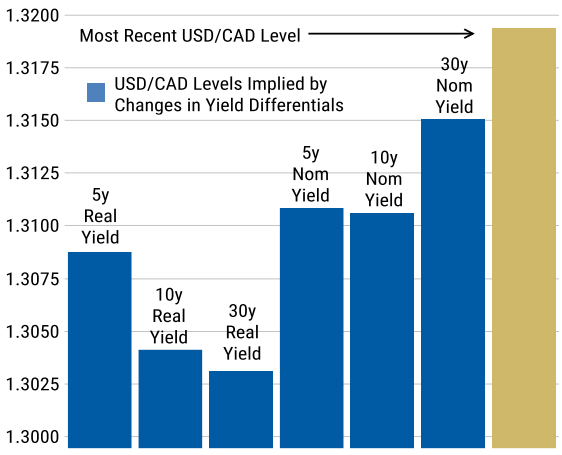
In addition, we expect the Canadian government to announce additional fiscal measures later this month at the Throne Speech scheduled for September 23. There have been unconfirmed media reports of the additional measures reaching $100bn, which would be added to existing measures which have pushed the annual deficit to an estimated C$343bn. The national cabinet will reportedly meet for several days next week (the week of September 14) to finalize plans for the Throne Speech. Those meetings could generate CAD-positive headlines as investor expectations for further fiscal expansion rise. However, we think **investors will be hesitant to add risk-sensitive positions** (such as short USD/CAD exposure) **ahead of a known risk event such as the US election**. That caution is likely to be especially pronounced given the potential for an initially confusing election outcome as the result may not be immediately clear.

Exhibit 91: Canadian yields have improved relative to US yields since before the COVID outbreak began



Source: Bloomberg, Morgan Stanley Research. Note: pre-COVID levels refer to Nov 19 - Jan 20 averages.

Exhibit 92: Changes in yield differentials alone suggest that USD/CAD should trade in the 1.3020-1.3150 range



Source: Bloomberg, Morgan Stanley Research.

In addition, USD/CAD has moved to roughly where realized moves in yield differentials would suggest the pair should trade. We estimate where USD/CAD should trade based purely on realized US-CA yield differential changes since prior to COVID using pre-COVID regression betas between USD/CAD and changes in yield differentials (see full discussion of methodology here). Our prior analysis looked only at where USD/CAD should trade reflecting realized 5y real rate differentials. We expand that analysis (using the same approach) to estimate where a range of realized rate differential movements (shown in Exhibit 91) suggest USD/CAD should trade. These estimates suggest only limited downside potential for USD/CAD – somewhere in the range of 1.3025 to 1.3150.

Higher Canadian rates (relative to US rates) could catalyze CAD strength. Our updated rates forecasts (Dollar bloc | Updating our forecasts) suggest that Canadian rates will rise to closer to Treasury yields than we previously expected (driven primarily by the expectation for robust Canadian net issuance – see Exhibit 93 and Exhibit 94). However, those forecasts continue to expect Canadian sovereign yields to trade below Treasuries.

Exhibit 93: US nominal yield spread over Canadian equivalents...

New	4Q20	2Q21	4Q21
2Y	-0.10	-0.10	-0.05
5Y	0.05	0.05	0.10
10Y	0.20	0.20	0.25
30Y	0.50	0.55	0.55

Source: Morgan Stanley Research

Exhibit 94: ...compared to out prior forecasts

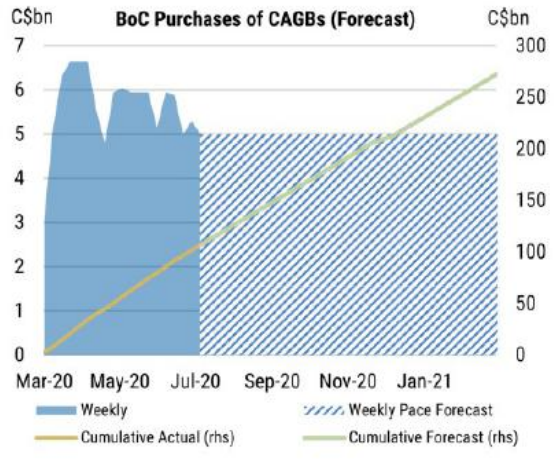
Old	4Q20	2Q21	4Q21
2Y	0.10	0.20	0.30
5Y	0.15	0.30	0.40
10Y	0.35	0.45	0.65
30Y	0.50	0.65	0.80

Source: Morgan Stanley Research

We are **closely watching both BoC policy and Canada's relative performance in containing COVID**. These factors represent risks to CAD, but we do not expect BoC policy or potential further COVID outbreaks to meaningfully shift the USD/CAD in the near term.

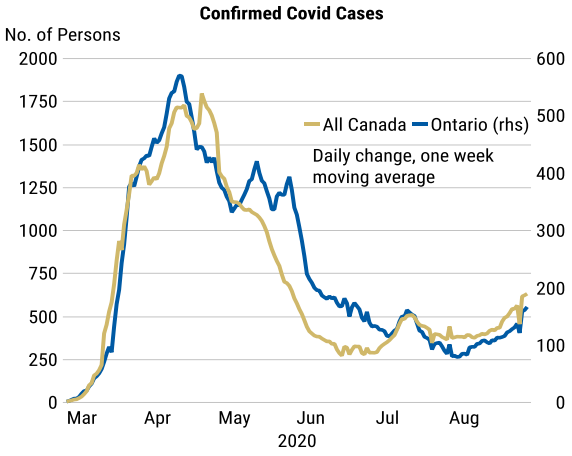
We **don't expect the BoC to signal near-term changes to the Bank's policy stance**. However, the BoC sounded upbeat at its September meeting as Governor Macklem signaled that the Canadian economy is entering a relatively slow-growth "recuperation phase." The BoC also reiterated that LSAPs will continue until the recovery is "well underway." Macklem said that "the recovery is further along than it was back in July, but we still have a long way to go." The Canadian government's considerable issuance needs (and recent CAD gains against USD) reinforce our base case expectation for continued LSAP purchases at the C$5bn/week pace at least until 2H21 (Exhibit 95). However, the BoC's stated view that the recuperation phase has commenced raises risks that the BoC tapers its purchase pace (to C$3bn/week) in 1H21.

Exhibit 95: We continue to expect a robust pace of BoC LSAPs



Source: Bank of Canada, Morgan Stanley Research

Exhibit 96: COVID-19 cases have ticked up recently



Source: Macrobond, Morgan Stanley Research

We are also **monitoring the recent rise in COVID-19 cases** in Canada. Ontario announced 200 new cases in one day for the first time since July, and announced a halt to its loosening of lockdown measures. Our economists note that policymakers have been successful in finding non-lockdown tools to combat COVID-19 outbreaks. The economic implications of such a potential outbreak are therefore relatively limited. However, there is a risk that a sustained or pronounced Canadian outbreak could sap investor confidence regarding the domestic economic outlook and boost USD/CAD.

G10 | Currency Summary

USD

-4.5%

Our view: Neutral **Risk skew: Neutral**

Watch: IP, Retail Sales, FOMC Decision, Housing Starts, Jobless Claims, UMich Survey

DXY **Support:** 92.75, 91.75, 89.50, 89.00, 88.25, **Resistance:** 93.75/94.00, 95.00, 95.75, 96.25

We maintain our tactical neutral stance on the USD, though we remain structurally bearish long-term. Longer-term, the USD-bearish themes of continued V-shaped recovery, dovish monetary and fiscal policymakers, and ample liquidity remain. However, we remain tactically neutral given the more balanced risk profile. Against these structural forces remain continued uncertainty over a possible fiscal deal; a non-negligible risk that markets may be overestimating the speed with which the Fed will roll out new easing measures; and a market which remains short USD, creating an asymmetric USD-upside skew. Selling the USD on a rally, particularly if driven by tighter financial conditions, might prove attractive as the Fed has proven reactive to financial conditions.

EUR

6.0%

Our view: Neutral **Risk skew: Neutral**

Watch: Industrial Production, ZEW survey, Inflation, Trade Balance and Current Account

EUR/USD **Support:** 1.1750/60, 1.1600, 1.1475, 1.1375, 1.1250/60, **Resistance:** 1.1900, 1.2000, 1.2225, 1.2400, 1.2500

We remain neutral on EUR after turning neutral post-Jackson Hole. The lack of big catalysts to watch on the European fiscal or monetary front over the coming weeks suggests EUR/USD will continue to be driven mostly by the USD leg. EUR/USD bounced from support around 1.18, with upper resistance around 1.2050. Market positioning remains long EUR. Increasing uncertainty over the US fiscal deal and elections, as well as the USD's negative correlation with risk, means there is limited potential for EUR/USD upside in the near future. President Lagarde said during the latest ECB meeting that they will continue to monitor EUR and assess its implications for the inflation outlook. While the ECB does not seem concerned with EUR around current levels, the possibility of verbal intervention should cap any meaningful appreciation for now.

JPY

-0.6%

Our view: Neutral **Risk skew: Neutral**

Watch: LDP election, BoJ MPM

USD/JPY **Support:** 105.80, 105.25, 104.25, 103.50, 103.00, **Resistance:** 106.50, 107.00. 107.40/50, 108.00/20

We turn neutral on JPY risk skew given our neutral risk skew on USD. The change in prime minister will likely have little meaningful impact on JPY. Chief cabinet secretary Suga, a front runner in the LDP leadership election, has already signalled that he would continue with the current Abenomics policy if elected. Moreover, the BoJ will likely take a clear stance in the upcoming BoJ MPM that it will not change the current monetary policy framework in response to the change in prime minister. The market also seems to take this view, limiting the impact on JPY. With few idiosyncratic catalysts in Japan, the focus turns to the USD side. In our view a resumption of broad USD weakness or materially higher UST yields are required to break the recent 105-107 range.

GBP

4.1%

Our view: Neutral **Risk skew: Neutral**

Watch: Brexit Headlines, BoE Rates Decision, Labour Market, Inflation, Retail Sales

GBP/USD **Support:** 1.2750, 1.2650, 1.2500, 1.2450, 1.2250, **Resistance:** 1.2900, 1.3050, 1.3150, 1.3200, 1.3300

We stay neutral on GBP for now. We expect GBP to trade sideways but be volatile both on the upside and downside between now and end-October. The UK has over the past week signaled a willingness to walk away from Brexit talks. The EU has given the UK until the end of September to amend a bill that goes against part of the Withdrawal Agreement, stating that such a bill would put at risk the ongoing negotiations or even potentially lead to legal action. Our economists still expect a pragmatic deal, maybe as late as November, but they now see a 40% risk of a WTO outcome. The market is neutrally positioned GBP at the moment. A deal could see GBP/USD rally up to 1.40, while no-deal could see a fall back down to 1.15.

CHF

-4.5%

Our view: Bearish **Risk skew: Bearish**

Watch: Sight Deposits

EUR/CHF **Support:** 1.0750, 1.0725, 1.0610/25, 1.0580, 1.0515, **Resistance:** 1.0840/50, 1.0875, 1.0900, 1.1000

We maintain our bearish view on CHF and keep our short EUR/CHF 6m put trade, believing risks remain skewed towards EUR/CHF upside eventually. EUR/CHF has continued trading in a narrow range, despite the pair trying to break above the 1.0850 level multiple times since early September. Recent global equity market underperformance did not substantially weigh on the pair as SNB interventions have continued to limit downside potential during such risk-off episodes. Brexit uncertainty means downward pressure on the pair will likely persist. We also flag an upcoming national referendum on 9/27 on whether the country will end the agreement of free movement of people with the EU. Withdrawal from that agreement would have negative implications for the broader relationship between the country and the bloc.

CAD

-3.3%

Our view: Neutral **Risk skew: Bullish**

Watch: Federal Cabinet discussions, CPI, Retail Sales

USD/CAD **Support:** 1.3150, 1.3050, 1.3000, 1.2950, 1.2800, **Resistance:** 1.3250, 1.3350, 1.3400, 1.3450, 1.3500

Federal Cabinet talks next week raise the risks of CAD-positive headlines as ministers plan a potentially fiscally expansionary Throne Speech on September 23. Investor positioning remains long USD/CAD according to the CFTC, and a fiscal deal in the US Congress (which remains our base case expectation) would boost risk demand. These factors argue for a stronger CAD, all else equal. However, growing investor caution ahead of the US election and relatively limited room for CAD gains implied by recent yield moves keep us neutral on USD/CAD.

AUD

6.7%

Our view: Neutral **Risk skew: Neutral**

Watch: Employment, RBA Minutes

AUD/USD **Support:** 0.7200, 0.7150, 0.7025, 0.6925, 0.6850, **Resistance:** 0.7300, 0.7400, 0.7625/75, 0.7800

We remain neutral on AUD/USD and see the skew as evenly balanced, similar to our view on the USD. AUD/USD should gain in a risk-positive environment and the longer-term risk profile for AUD/USD remains positive. However we are more tactically neutral given that markets are positioned short USD, creating an asymmetric risk profile on a positioning unwind, and given various risk events in the coming weeks such as US Congress and a possible fiscal deal and the US election. We would ultimately view a dip in AUD/USD as an attractive buying opportunity particularly if it were to fall toward 0.68-0.69. AUD/USD remains bullish technically for now.

NZD

4.2%

Our view: Neutral **Risk skew: Bearish**

Watch: Migration, GDP

AUD/NZD **Support:** 1.0825/50, 1.0750, 1.0650/75, 1.0575, **Resistance:** 1.0950, 1.1000, 1.1175, 1.1290, 1.1325/50

We continue to see NZD/USD risks as skewed to the downside, but not enough to make us outright bearish. The RBNZ remains one of the most dovish central banks in the G10 and the structural theme of foreign selling of NZGBs should continue to put downward pressure on the currency. We remain bullish AUD/NZD for this reason. While USD faces longer-term structural headwinds, we think in the short term risks are more balanced given that the market is positioned short USD and the various risk events forthcoming (e.g., the US election, Congress and a possible fiscal deal). We continue to be bearish NZD on crosses like AUD/NZD.

SEK

-7.6%

Our view: Neutral **Risk skew: Neutral**

Watch: Unemployment Rate, House Prices

EUR/SEK **Support:** 10.32, 10.29, 10.26, 10.24, 10.22, **Resistance:** 10.40, 10.44/45, 10.50, 10.60

We see EUR/SEK continuing to trade sideways in the near term, with upside risks towards 10.70 in the coming months. In the near term, EUR/USD will likely trade in a range and Brexit concerns should keep any downside pressure on EUR/SEK (e.g., from better equity performance) modest. The pair remains in a medium-term uptrend with ~10.25 the key support. A clear break above 10.42 may be needed to generate more upside momentum. In the coming months, though, the positive catalysts for risk market support may start to fade and our economists also see Swedish data potentially starting to slow after the initial post-lockdown surge, which may increase Riksbank easing expectations to weaken the currency.

NOK

-6.6%

Our view: Neutral **Risk skew: Bearish**

Watch: Trade Balance, Regional Network Survey

NOK/SEK **Support:** 0.9650, 0.9550, 0.9500, 0.9450, 0.9350, **Resistance:** 0.9800, 0.9925, 0.9950/60, 100.00/10

We remain neutral on NOK but now see the risks as skewed to the downside in the very near term. NOK is vulnerable to any potential weakening in risk appetite, as it is illiquid and short EUR/NOK positioning in the options market is large. Recent growth data from Norway has also missed expectations, with manufacturing PMI staying in contraction territory, which may hold the Norges Bank back from responding to higher domestic inflation and house prices. For NOK to rally, oil prices would need to move higher but here, our oil analysts see limited upside in the near term. The first key level to watch on the upside in EUR/NOK is 10.80 – a significant break may give it more upside momentum. We suggest buying a 3m EUR/NOK call spread (buy 50D call, sell 25D call) at a cost of 1.03% as a risk hedge.

Charts show 3M performance against USD, as normally quoted and DXY for USD. Click on any currency for a reference webpage on Matrix.

Inflation-Linked Bonds

The 2020 Institutional Investor (II) Global Fixed-Income Research poll is open. If you enjoy our work, please rate us five stars in the following categories: USA: Economics & Strategy > Treasury Inflation-Protected Securities; Developed Europe: Economics & Strategy > Inflation-Linked Bonds; Japan > Interest Rate Strategy. Thanks for your readership and support!

United States
We think real yields can be lower even if the Fed makes no major changes to its policy or communication, because improving inflation and growth data in the face of an on-hold Fed can also lower real yields. Besides, 9bp of positive carry over the coming six weeks also helps maintain our long 5y TIPS position.

We suggest investors not get bogged down by the weakness in rent inflation because (1) trimmed mean CPI suggests strong underlying inflation trend is strong, (2) TIPS carry is strong, for yet another month, (3) the details of rent inflation components are mixed and not all out negative, and (4) our deep dive into CPI inflation suggests strong near-term inflation.

Japan
This week we (1) touch on recent price movements in oil and accommodation, (2) consider recent supply/demand conditions, and (3) summarize our views on the potential ramifications of fiscal and monetary policy for our own forecasts and the JGBi market.

United States | Don't get bogged down by rent inflation

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Stay long 5y TIPS

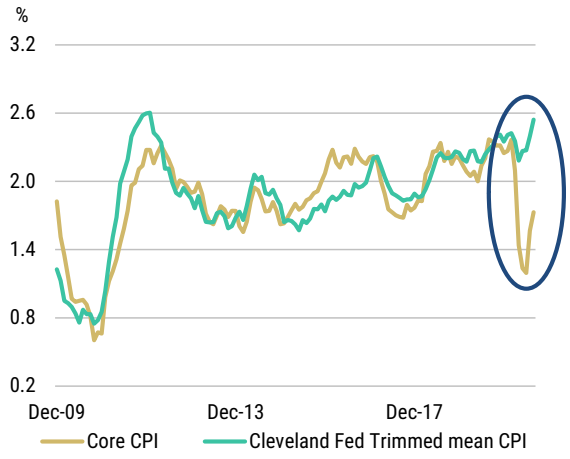
As we pare down our expectations for fiscal stimulus (see Interrupted by Fiscal Failings) and remove our curve steepening trades, we continue to put faith in the Fed being able to maintain low real yields, and faster breakevens. Note that the Fed doesn't need to necessarily ease further, or provide more detailed forward guidance to lower real yields further. We think real yields can be lowered even if the Fed makes no major changes because improving inflation and growth data in the face of an on-hold Fed can also lower real yields.

We have argued that 5y real yields can reach -1.8% over the medium term, as the V-shaped recovery continues and inflation continues to surprise expectations. The August core CPI print, at 0.39% m/m, is the third consecutive core CPI surprise, and the July and August prints are the two highest monthly prints in 30 years. However, details matter, and one notable detail in the August print is the weakness in rent inflation.

Why TIPS investors shouldn't be bogged down by rent inflation?

1. Trimmed mean CPI suggests strong underlying inflation trend is strong: Note that trimmed mean CPI for the month of August excludes the biggest outliers like used car prices, which have been slated as the reason for the big upside surprise in August. Trimmed mean CPI is up 20bp from March 2020 to August - the first six months of the crisis period - in sharp contrast to how trimmed mean was down ~1% in the last six months of 2008. We think core CPI will converge towards trimmed mean CPI over the coming months (see Exhibit 97).

Exhibit 97: Trimmed mean CPI vs. core CPI over the last ten years



Source: Haver, Morgan Stanley Research

Exhibit 98: TIPS carry over the next six months

Carry (bp) Per Month			Real Yields
MONTH	5Y	10Y	30Y
Sep-20 Stub	4.8	2.4	0.9
Oct-20	4.4	2.3	1.0
Nov-20	-1.0	-0.2	0.1
Dec-20	-1.3	-0.3	0.1
Jan-21	-5.1	-2.0	-0.5
Feb-21	-9.1	-3.8	-1.1

Source: Bloomberg, Morgan Stanley Research

2. TIPS carry is strong, for yet another month: While the details of August CPI are subject to different interpretations, the overall result is unquestionably positive for TIPS carry. 5y TIPS offer an additional 4.5 bp of carry in October, in addition to about 4.5bp carry for the remainder of September. We think this 9bp cushion over the next 6 weeks is helpful in maintaining long 5y TIPS position. In general, as we have seen, 5y real yields have resisted moving higher, and we think that resistance will continue, making the carry cushion even more valuable.

3. Particularly on rent inflation: Recall that June CPI print was weak, followed by a recovery in July, suggesting there is no trend in the rent inflation just yet. The weakness in core CPI in the last six months is coming largely from rent – which shouldn't be surprising given that it is the only major Phillips curve sensitive component. Points to note:

- **Decomposing rent into class A vs. class B** – as we have envisioned – class A rents (mostly multifamily, big cities) are leading the weakness, while class B (more single family, smaller cities) seems to have stabilized (see Exhibit 100). We think these two components will offset each other over the coming months, leaving rents at a lower but stable level.

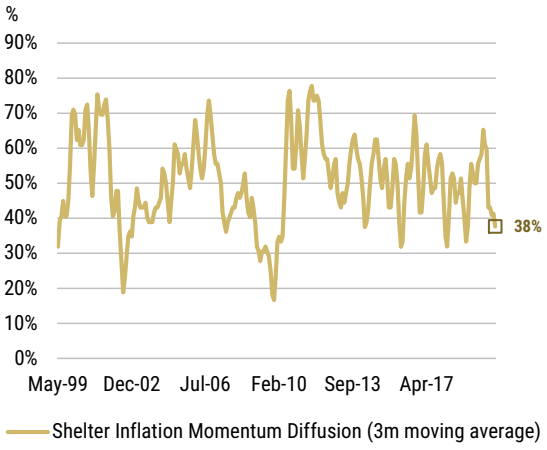
- **Among regions,** the weakness in shelter in the last 3 months has mostly come from the west and the south regions. In August, weakness in Denver and Dallas led by weakness. In the west, it came from San Diego, San Francisco and Los Angeles.

- **Our rent diffusion index** (see Exhibit 99), which measures how many regions are seeing a weaker trend vs. positive trend, moved slightly lower to 38%, still well above the 2009-2010 levels. We have been at these levels in 2018 and 2019 and rebounded from them.

- **Overall,** while rent inflation has slowed, we still see rent inflation stabilizing at current/slightly higher levels, given the focus on rent evictions, as well as the strong housing data, especially in class B regions.

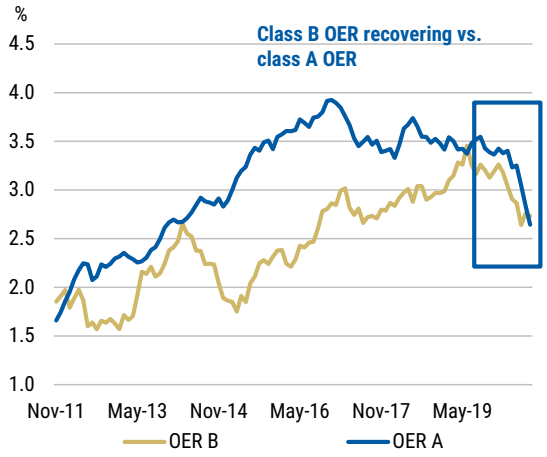
4. Our deep dive into CPI inflation suggests strong near-term inflation: A combination of pandemic demand positive components, capacity constrained components, as well as some reversal in pandemic demand negative components can make for a good short-term inflation impulse, even if rent inflation stays weak. We take a deep dive into CPI components next.

Exhibit 99: Rent diffusion index over the last ten years



Source: Haver, Morgan Stanley Research

Exhibit 100: Class A vs. class B OER inflation over the last ten years



Source: Bloomberg, Morgan Stanley Research

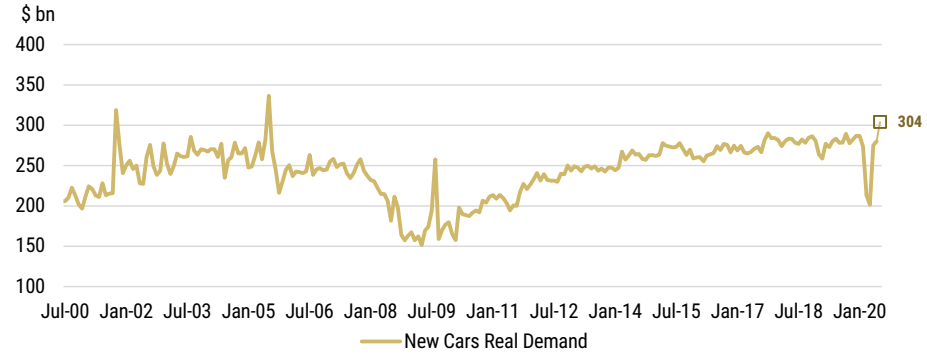
What's going on inside the CPI basket?

To understand the factors driving inflation in various categories we coupled August CPI data with July PCE real demand data into four different buckets, continuing the same analysis we did last month in How Sustainable Is The Rise In Core CPI?. Coupling inflation numbers with real demand allows us to look at inflation in the context of demand and supply drivers. We maintained all the components we included in our June-July analysis and added the Professional Services component.

We make the following observations:

New cars demand surpassed its December 2019 level and reached its highest value since 2005. This pushed the category from the "Holding Strong" bucket to the "pandemic demand positive" bucket for the first time since the pandemic began. Continued strength in new and used car prices, alongside robust demand numbers as a post pandemic trend, likely supported by fiscal stimulus from the CARES act, suggests that new and used cars could stay strong for the coming months.

Exhibit 101: New Cars Real Demand over the last twenty years



Source: Haver, Morgan Stanley Research

Even though meats inflation decreased in August, a strong rise in demand in July (4.4% m/m) has moved the component from the "capacity constrained" bucket to the "pandemic demand positive" bucket. In contrast, a negative July demand shock (-3.25% m/m) dragged housekeeping supplies form the "Pandemic Positive" bucket to the "Holding Strong" bucket.

The newly included Professional services (Physicians/Dental/Eyes/others) component formed part of the "capacity constrained" bucket as inflation has remained steady and demand has decreased since December 2019. Shelter demand and inflation remained flat over July and August, supporting our idea of a strong and resilient housing market and keeping the component in the "Holding Strong" bucket (see Why Rent Inflation Decline Isn't Worrying Us Yet?). Interestingly, recreation services shifted from the "pandemic demand negative" bucket to the "capacity constrained" bucket. A 10.4% m/m increase in demand and a positive inflation print pushed the component to "capacity constrained".

Demand and inflation have improved significantly for many "pandemic demand negative" components. Airline fare annualized demand increased from -93.5% in June to -50.3% in July, a 58.3% increment in month to month terms, while inflation since December 2019 increased from -42.21% to -31.82%. A 41.4% month to month increase in Public Transportation real demand pushed an annualized value of -93.5% in June to -63.6% in July. Similarly, prices increased from -29.57% since December 2019 in July to -24.19% in August for the component. Motor fuel demand increased from -23.6% in June to -12.3% in July in annualized terms as inflation experienced an increment from -38.28% to -29.99%. Moreover, overall Energy annualized demand change from December 2019 turned positive for the first time since the pandemic; however, this dynamic was not enough to push the component out of the "pandemic demand negative" bucket since, even though inflation increased, it remains significantly negative at -17.55%.

Exhibit 102: Details of various CPI components alongside demand trends

Category	Weight (%)	August CPI Change Annualized (Since Dec 2019) (%)	2019 (%)	Contribution to CPI (%)	July Demand Change Annualized (Since Dec 2019) (%)	Pandemic Positive	Capacity Constrained	Holding Strong	Pandemic Negative
Food at home	8.0	6.28	0.75	51.91	12.3	Yes	No	No	No
Household furnishings	3.8	4.49	0.34	21.67	23.0	Yes	No	No	No
Transportation commodities less fuel (Cars)	6.9	4.11	-0.11	41.57	13.5	Yes	No	No	No
New cars	3.7	1.29	0.06	5.08	10.4	Yes	No	No	No
Used cars	2.5	8.77	-0.67	36.28	20.2	Yes	No	No	No
Meats, Poultry, fish n eggs	1.9	7.16	2.27	12.93	10.9	Yes	No	No	No
Meats	1.1	8.06	3.58	6.70	8.7	Yes	No	No	No
Food away from home	6.3	3.77	3.10	6.65	-35.9	No	Yes	No	No
Professional services (Physicians/Dental/Eyes/others)	3.7	2.51	1.65	7.28	-7.7	No	Yes	No	No
Recreation Services	3.8	0.72	2.61	-5.17	-54.4	No	Yes	No	No
Education Services	6.3	3.14	2.01	7.33	-14.8	No	Yes	No	No
Shelter	33.5	2.09	3.24	-60.61	1.1	No	No	Yes	No
Housekeeping supplies	0.9	7.33	0.45	8.84	-2.5	No	No	Yes	No
Wireless (Cellphones)	1.9	6.69	-0.19	16.25	-3.7	No	No	Yes	No
Energy	6.1	-17.55	3.59	-132.99	3.8	No	No	No	Yes
Out of town lodging	1.0	-14.46	-0.17	-21.06	-78.5	No	No	No	Yes
Transportation services	5.0	-6.22	0.63	-50.03	-36.1	No	No	No	Yes
Public transportation	1.1	-24.19	1.17	-36.31	-63.6	No	No	No	Yes
Apparel	2.7	-6.89	-1.12	-26.77	-3.9	No	No	No	Yes
Airline fare	0.6	-31.82	1.80	-27.03	-50.3	No	No	No	Yes
Motor Fuel	2.8	-29.99	7.82	-108.68	-12.3	No	No	No	Yes

Source: Bloomberg, Haver, Morgan Stanley Research

Trade idea: Maintain long 5y TIPS at -132bp

Trade idea: Maintain 30y breakeven wideners at 178bp

Japan | Further signs of weakness

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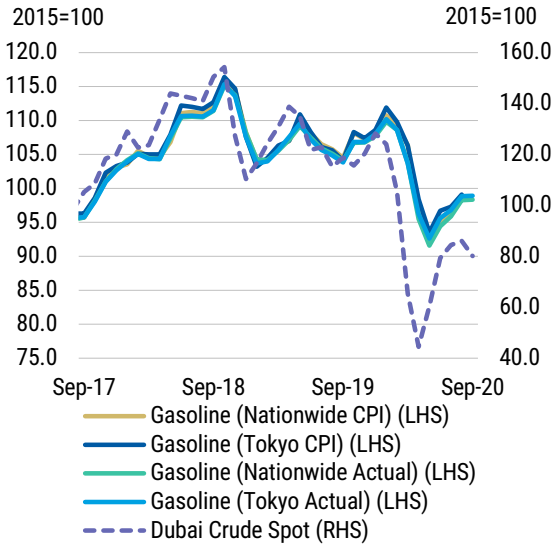
This week we (1) touch on recent price movements in oil and accommodation, (2) consider recent supply/demand conditions, and (3) summarize our views on the potential ramifications of fiscal and monetary policy for our own forecasts and the JGBi market.

Price trends

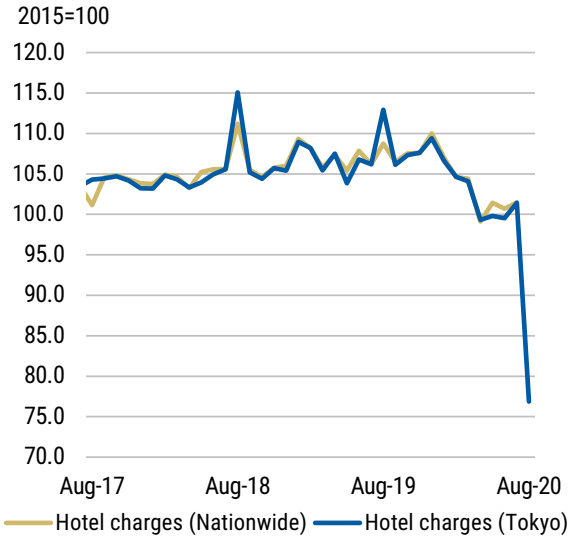
Oil prices have started to fall once again. Our strategists have recently changed their oil price forecasts but prices remain low in the short term (see The Oil Manual: Oil's Unstable Equilibrium Continues (9 Sep 2020) for details), suggesting that Japan-style core CPI (All items, less fresh foods) inflation rate could soon be set to face further downward pressure (from actual oil prices) in addition to the ongoing impact of the COVID-19 crisis. Gasoline prices have indeed been rising of late on a weekly basis, but are likely to start falling from November or December assuming that the usual two- to three-month lag applies (Exhibit 103).

Exhibit 103: Gasoline and crude oil prices



Source: Ministry of Internal Affairs and Communications, Bloomberg, Morgan Stanley Research

Exhibit 104: Hotel charges (CPI, seasonally adjusted)



Note: Seasonally adjusted by Morgan Stanley Research
Source: Ministry of Internal Affairs and Communications, Morgan Stanley Research

In 'Japan Economics / Rates Strategy: CPI (July 2020 Nationwide) and JGBi Strategy: Japan-style Core Still Holding Up' (21 Aug 2020) we pointed out that the Japan-style core CPI inflation rate had yet to start falling, but a look at preliminary Ku-area of Tokyo CPI data for August suggests that the nationwide index may at some point begin to face downward pressure as accommodation prices are driven significantly lower by the government's "Go To Travel" campaign (launched in late July) (Exhibit 104).

Tokyo has indeed been excluded from the campaign to date, but Statistics Bureau estimates nevertheless point to an impact of around -0.4%pt at the nationwide level after allowing for 'Hotel charges' having a lower index weight outside Tokyo.

Supply/demand

These apparent negatives for the Japan-style core inflation rate are, all else equal, liable to reduce the appeal of JGB linkers from an inflation carry perspective. Against this backdrop it is perhaps possible to draw at least some reassurance from the recent calmness of the JGBi market. The real yield on the newest issue did climb into positive territory at the start of September, but price action has remained comparatively limited to date. That said, we do still see a risk of JGB linkers facing greater selling pressure as inflation slows and the Bank of Japan deprioritizes its +2% "price stability target" in order to concentrate on its COVID-19 response.

For the time being we suggest focusing mostly on oil price movements, the September 16–17 Bank of Japan Monetary Policy Meeting (see 'BoJ Watch: September MPM Preview' (10 Sep 2020) for details), and any reaction of foreign JGBi investors to next week's nationwide CPI release.

As discussed in 'Japan Strategy & Economics: Abe-san's legacy likely to be lasting' (28 Aug 2020), we do not envisage any material changes in either the Bank of Japan's monetary policy or the government's fiscal policy for at least the time being.

Somewhat paradoxically, however, this uneventfulness on the policy front could serve to drive down the expected inflation rate—thereby increasing the risk of a JGBi selloff—by sending a signal that policymakers envisage continued weakness in prices. Taking all of the above into account, our current assessment is that the risk/reward balance for JGB linkers remains skewed to the downside.

Short-Duration Strategy

The 2020 Institutional Investor (II) Global Fixed-Income Research poll is open. If you enjoy our work, please rate us five stars in the following categories: USA: Economics & Strategy > Short-Duration Strategy; Developed Europe: Economics & Strategy > Interest Rate Strategy; Japan > Interest Rate Strategy. Thanks for your readership and support!

United States

In the US, we answer some of the more popular questions that have arisen in light of Vanguard's decision to transition their Prime Fund to a government fund. More specifically, we address reasons that led to this decision, if other funds have previously made this transition, what happened to prime funds the last time we were in ZIRP, and what impact we expect this will have on funding markets.

Overall, we expect the direct impact of Vanguard's transition on funding markets to be quite muted given their small positioning in CP and CDs. The bigger risk lies in whether or not other large prime funds with greater CP and CD holdings will follow suit. If so, this could pose widening risks to LIBOR/OIS and FRA/OIS.

United States | Vanguardium Leviosa

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Vanguard Transition FAQ

Vanguardium Leviosa - a well known spell that is used to transform a prime MMF into a government MMF. As well known, Vanguard has decided to perform a little magic and transition $125bn from its Vanguard Prime MMF into a government MMF likely sometime later this month. Since this announcement, there have been many questions that have arisen surrounding this transition. Here, we aim to dispel some common misbeliefs and conjure up answers to these questions.

Is Vanguard the first fund to do this? Will other firms follow suit?
Vanguard is not the first fund to make this transition, but it is the largest, which is perhaps why it has garnered more attention. Earlier this year, Fidelity and Northern Trust both announced transitions of funds.

Fidelity's Money Market Prime Money Market Portfolio (FIPXX) and Money Market Prime Reserves Portfolio (FHPXX) were both closed to new investments on August 12th and were shut entirely on August 14th. Combined, the two funds had $14bn in AUM, all of which were returned to investors. It is worth noting that these two funds were both institutional funds compared to the fund Vanguard is shutting down, which is retail.

Northern Trust also shut down a prime MMF. They stopped accepting orders for their Northern Institutional Prime Obligations Portfolio (NPAXX) after the close of trading on June 12th, and liquidated the fund entirely on July 10th. At the time of closure, the fund only had $1.7bn in AUM.

It is very possible that other, larger funds, follow Vanguard and transition prime MMF into government MMF, especially given that (1) there is now a clear precedent for the switch and (2) rates are likely to remain near 0% for many years to come. These transitions may well take place over the coming months or even years, and there will be large variability in timing depending on fund manager, as well as fund size and type.

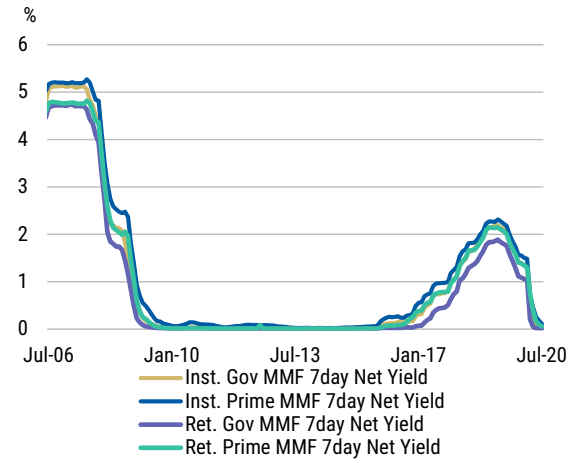
Why have other funds switched to gov MMF? Are Vanguard's reasons the same?
The main rationale for switching to gov MMF is that in Zero Interest Rate Policy (ZIRP), the yield pickup from prime MMF is no longer sufficient to take on increased risks of a prime MMF of redemptions, illiquidity of assets, and headline risk.

Anecdotally speaking, back in March and April, prime MMF were experiencing significant AUM outflows as investors were taking cash out of prime MMFs and putting them into safer gov MMF during the severe risk-off period.

Normally, when a fund is facing redemptions, they will sell assets in order to meet those redemptions. However, in March and April, liquidity in the CP and CD markets was quite poor. Even liquidity in Treasury markets was poor, so even if they tried to sell of USTs (old notes or T-bills), they may have had to do so at a discount.

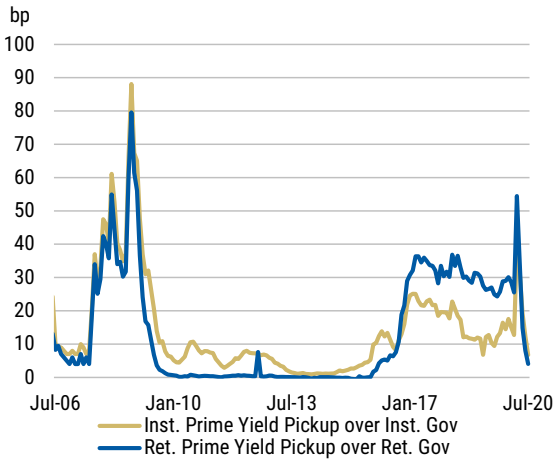
Had the Fed not stepped in to support funding markets and short-term credit markets, funds could have faced some of the headline risk that the Reserve Primary Fund experienced in the financial crisis. Though prime MMFs now have floating NAV (since MMF reform) to prevent "breaking the buck", having a NAV fall well below $1 could still lead to increased redemptions and increased illiquidity in CP/CD markets, leading to a vicious cycle.

Exhibit 105: 7-day net yield of different MMF types



Source: Crane Data, Morgan Stanley Research

Exhibit 106: Yield pickup of prime funds over their gov fund counterparts



Source: Crane Data, Morgan Stanley Research

When yields are higher, a prime MMF manager may be willing to take on these increased risks for that yield advantage. However in ZIRP, not only does the level of yields fall for all MMFs as the Fed cuts EFFR to zero (see Exhibit 105), but also the yield advantage of prime MMFs falls.

We think its important to note that the yield advantage should be viewed in terms of absolute bps and not relative yield. For example, when government funds earn 1% and prime funds earn 1.20%, they are earning a 20bp pickup over gov MMFs, not a 20% increase. Similarly, when gov MMFs earn 10bp and prime MMFs earn 20bp, this should be viewed as a 10bp pickup, not 200% of government MMF yield.

In absolute bp, the yield advantage fell below 10bp for institutional prime MMFs for the entirety of 2010-2015 when the Fed began raising rates again. This yield advantage was even lower for retail prime MMFs (of which Vanguard prime is one) (see Exhibit 106).

In fact, many prime MMFs have to eliminate their higher fees just to remain competitive with government MMFs on an absolute basis, so fund managers aren't even being compensated for these higher relative risks.

Vanguard's rationale for switching to a government fund is no different. When asked about the decision, the Vanguard CIO Greg Davis responded as follows (our **emphasis**):

> *"Vanguard investors prioritize capital preservation for their money market investments, and we believe that the **rewards of even the most conservatively managed prime funds are no longer worth the risk**. We are committed to structuring and managing our money market funds prudently while **preserving their safety and liquidity**, and are confident these changes will best position the fund to continue to meet the expectations of our clients, while still providing a **competitive yield** over the long term."*

Similar themes appear that the yield pickup is no longer "worth the risk" and the priority remains providing "safety and liquidity" to clients.

What are some of the differences between prime MMF and gov MMF that make prime MMF less advantageous in a ZIRP?
So, we now know that many funds are transitioning as the diminished yield pickup is no longer worth the disadvantages a prime MMF faces compared to a gov MMF. So what are some of those key differences?

First off, since MMF reform in 2016, there are characteristics of prime MMFs that make them less attractive than gov MMFs. Most notably, prime MMFs can have floating NAVs and also have redemption gates and liquidity fees. While a floating NAV is not necessarily a bad thing inherent to itself, as it reduces the stigma of "breaking the buck", it reduces the liquidity of prime MMFs as investors cannot withdraw funds at $1 a share. the NAV has to be calculated before investments can be withdrawn. Liquidity fees and redemption gates pose challenges to investors as they limit how much they can withdraw in periods when prime MMFs are experiencing large redemptions.

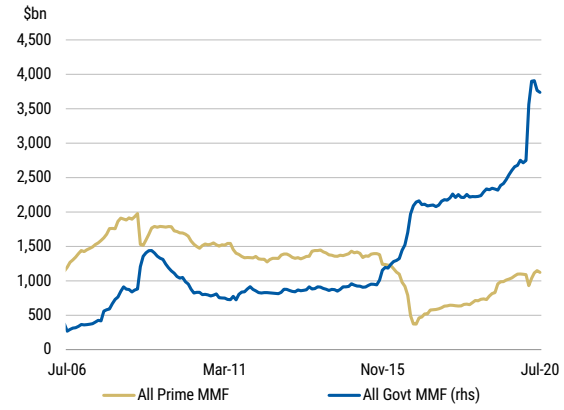
As such, investors in prime MMFs will require a higher yield to compensate for these disadvantages that a prime MMF presents over gov MMF.

Secondly, there is a broader set of assets that prime MMF invest in versus gov MMF including CP and CD. These markets tend to face greater liquidity issues in times of stress (i.e. GFC or March 2020). Given the potential challenges these markets can pose and the greater operational complexity that comes with more diverse set of assets, prime MMFs tend to have higher fees.

These fees tend to be about 6-8bp higher than the fees that government MMFs have. Though 6-8bp may not seem like a big difference, it becomes a much more significant portion of the yield pickup that prime MMFs have over gov MMFs in ZIRP. Many MMFs, both prime and gov alike, look to reduce or even eliminate fees in a ZIRP environment. Of course, doing so is more costly for prime MMFs.

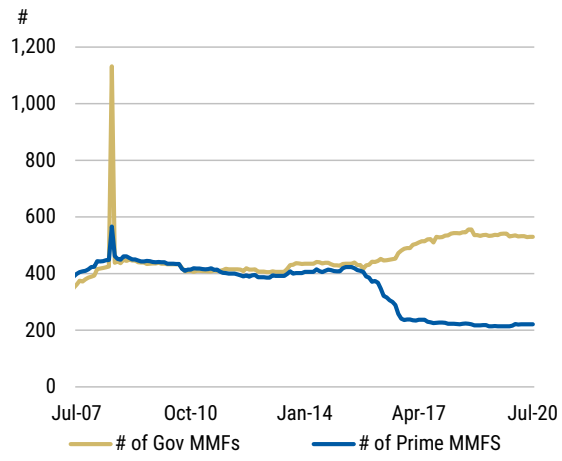
Did we see a similar pick up in transitions from prime MMF to gov MMF in the last ZIRP?
In the previous ZIRP regime and fallout of financial crisis, there was some loss of prime MMF AUM and the number of outstanding funds also decreased (see Exhibit 107and Exhibit 108). Though the decline in prime MMF AUM was steady throughout 2009-2015, the largest declines occurred in 2008 after Reserve Primary Fund broke the buck and in late 2015-2016 as a result of MMF reform.

Exhibit 107: AUM in prime and government MMFs



Source: Crane Data, Morgan Stanley Research

Exhibit 108: # of prime and government MMFs



Source: Crane Data, Morgan Stanley Research

In a similar time frame, the number of outstanding funds also fell from 452 in September 2008 to 387 by September 2012. The number fell even further once MMF reform occurred as the changes to prime MMFs in MMF reform were deemed disadvantageous (see above). The number of prime funds in existence has not since recovered. This next ZIRP could lead to another period of transitions from prime MMFs to government MMFs.

Will the entirety of the $125bn be transitioned to gov MMF or will some of this remain in prime MMFs?
Our initial view is that when the switch is made later this month, yes, Vanguard will move all remaining AUM into a government fund.

However, leading up to the switch, if retail investors are particularly keen on investing in a prime fund, they will withdraw funds from the Vanguard Prime Fund and place it into other prime funds. As such the AUM in Vanguard may not be a full $125bn at the time of transition.

It is hard to know exactly how much of this latter described movement of cash from Vanguard Prime into other prime funds will occur, and therefore, how much AUM the Vanguard fund will have at the time of the transition. We would suspect that anywhere from 50%-80% of what is currently in the fund will be transitioned to gov MMFs. In fact, as of end of August, Vanguard AUM was at $131bn.

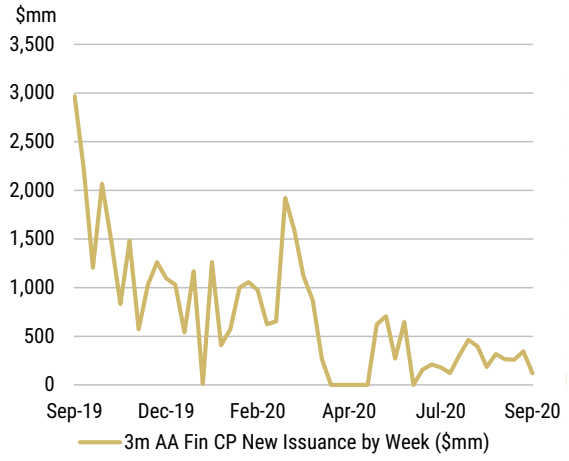
How will unsecured funding markets and broader funding markets be impacted?

At this point it is well known that the Vanguard Prime Fund was not a large owner of CP. As of the end of July, the fund owned ~6% of all prime MMF's holdings of CP. By the end of August, this had fallen to 3.6%.

Even so, there is still marginal CP supply that has to find a new buyer. Who will pick up the slack? For one, there are still plenty of other prime MMFs to purchase CP. Further, bank portfolios, which are currently flush with cash, tend to buy CP.

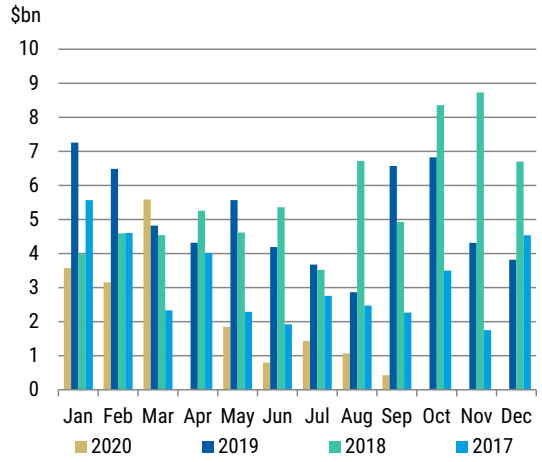
It is also entirely possible that CP and CD supply may decline. Given that much of the system is flush with cash, particularly financial issuers of CP, there is less overall need for short term borrowing. This is evident by the low supply levels of financial CP seen over the last couple of months both in outright levels and relative to past years (see Exhibit 109and Exhibit 110).

Exhibit 109: 3m AA financial CP new issue by week ($bn)



Source: Bloomberg, Morgan Stanley Research

Exhibit 110: 3m AA financial CP issuance by month in 2017-2020



Source: Bloomberg, Morgan Stanley Research

Though we expect issuance to pick up modestly in September and October seasonally, if supply remains muted as it has from April to September, there may not be any impact at all from Vanguard moving. Further, the move from prime MMF to government MMF may result in somewhat offsetting impacts on LIBOR-T-bill and T-bill-OIS such that LIBOR-OIS is largely unchanged.

Though Vanguard may be buying less CP and CD, resulting in a widening of the spot Ted spread (3m LIBOR - 3m T-bill), they will be increasing purchases in UST and repo spaces, driving demand somewhat higher there. This could richen T-bills ever so slightly, somewhat offsetting any changes to LIBOR-T-bill. Again, given the magnitude of purchases we are talking about, we expect these effects to be indiscernible.

The largest impact to funding markets could arise if other large prime MMFs, with much larger holdings of CP and CD, follow in Vanguard's footsteps and make the transition. If this occurs, the widening of spot Ted spread is likely to be greater than any richening that could occur to T-bills and thus, LIBOR-OIS would be likely to widen.

Interest Rate Derivatives

The 2020 Institutional Investor (II) Global Fixed-Income Research poll is open. If you enjoy our work, please rate us five stars in the following categories: USA: Economics & Strategy > Interest Rate Derivatives; Developed Europe: Economics & Strategy > Interest Rate Strategy; Japan > Interest Rate Strategy. Thanks for your readership and support!

United States

In the US, we continue to suggest investors stay long 3m10y ATMF straddles, delta hedged. Though upper left vol will likely continue to move lower, both from gamma selling and range-bound rates, we see two catalysts for upper right vol to move higher: 1) uncertainties around stimulus package timing and sizing, and 2) realized vol picking up into the US election.

Without material progress in negotiations on CARES 2, it appears that the risks of no stimulus bill have risen considerably, though our public policy team's view remains that a deal is the most likely outcome. Therefore, headline risks remain as negotiations progress (or not). Given these headline risks that could arise, we think there is potential for gamma to perform, particularly in the upper right.

In FX and Rates Volatility Are Falling, we showed that US rates realized volatility tends to dip ~3.5months ahead of the election but pick up ~2months ahead of the election. Two months prior to this year's election would have been September 3rd. And, as expected, we have seen realized vol begin to pick up. We expect it to continue to increase over the next two months.

Lastly, we provide an update on expiry and tail switch term structures. The expiry term structure in gamma and the intermediate space on short-end and belly rates continues to steepen, while the expiry term structure on long-end rates remains inverted. The tail switch term structure has continued to steepen in gamma and intermediate expiries, while remaining relatively flat on long-dated expiries.

United States | A 1-2 punch for upper right vol

MORGAN STANLEY & CO. LLC

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Staying long 3m10y ATMF straddles, delta-hedged

Over the last week, short-dated expiries are mostly lower across all expiries, though upper-right vol is higher than its near-cycle lows in July. Over the next few months, we see two major catalysts for upper right vol to move higher: (1) uncertainty surrounding an additional fiscal stimulus package and (2) the US election.

Exhibit 111: Snapshot of Vanilla Swaption Vol

Snapshot: 09/10		Tail				
		1y	2y	5y	10y	30y
Expiry	1m	16.2	18.7	30.9	53.8	75.6
	3m	19.4	21.8	41.2	67.3	87.4
	6m	18.1	22.2	42.3	65.6	80.5
	1y	21.5	26.3	44.6	64.3	75.1
	2y	32.2	37.8	51.4	64.3	71.1
	3y	43.3	46.4	55.8	64.5	68.6
	5y	56.2	57.8	61.5	64.5	65.1
	10y	63.8	63.7	63.3	x	59.2

Source: Bloomberg, Morgan Stanley Research

Exhibit 112: 1w Change in Vanilla Swaption Vol

Change: 09/03 to 09/10		Tail				
		1y	2y	5y	10y	30y
Expiry	1m	(0.1)	(0.2)	(0.4)	(0.6)	(0.8)
	3m	(0.2)	(0.7)	(1.4)	0.1	(0.1)
	6m	0.2	(0.1)	0.0	1.8	1.5
	1y	(0.4)	(1.0)	(0.2)	0.7	1.0
	2y	(0.4)	(0.7)	0.1	0.6	0.7
	3y	(0.2)	(0.6)	0.1	0.6	0.9
	5y	0.0	0.3	0.3	0.9	0.9
	10y	0.1	0.6	0.7	0.8	0.7

Source: Bloomberg, Morgan Stanley Research

Let's go through a quick recap of the two catalysts listed above.

(1) Uncertainty surrounding the passage of an additional fiscal stimulus package

Without material progress in negotiations on CARES 2, it appears that the risks of no stimulus bill have risen considerably, though our public policy team's view remains that a deal is the most likely outcome. Therefore, headline risks remain as negotiations progress (or not). Given that the market continues to expect about $1-1.5tn of stimulus, any deviations to this (including no bill at all) could impact rates, particularly in longer-dated tails.

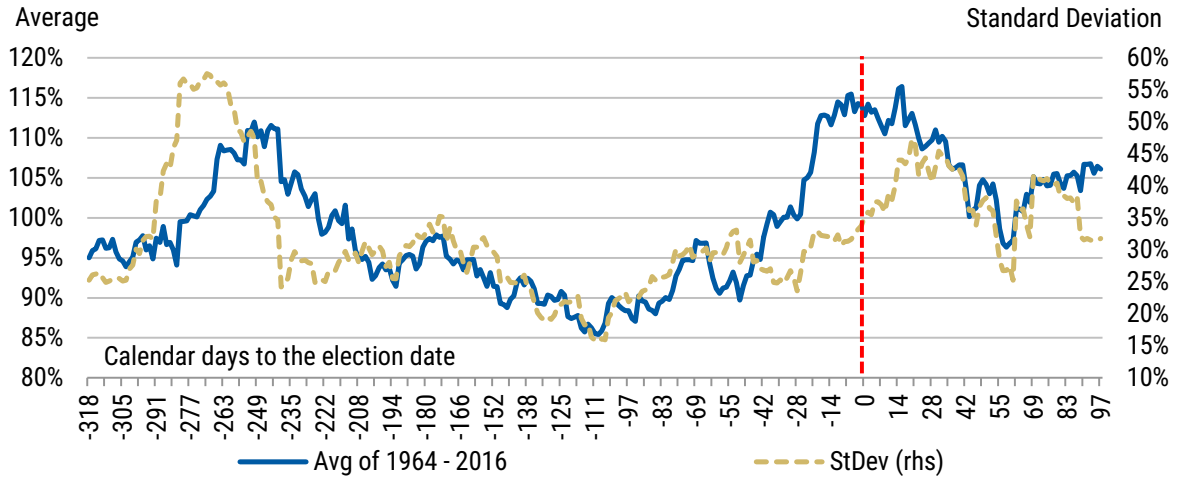
Given the headline risk that could arise associated with CARES 2, with both the timing and sizing of the bill, we think there is potential for gamma to perform, particularly in the upper right.

(2) Realized vol increasing 2 months out from US election

In FX and Rates Volatility Are Falling, we showed that US rates realized volatility tends to dip ~3.5months ahead of the election but pick up ~2months ahead of the election.

Exhibit 3 illustrates the average of 1m rolling realized vol of 10y UST yield scaled by the annualized 6m realized volatility by the end of the previous year in election years since 1964. The x-axis shows the calendar days to the election date, i.e. t=0 is the election day.

Exhibit 113: Average of 1m rolling realized vol of 10y UST yield (scaled) during elections from 1964 to 2016

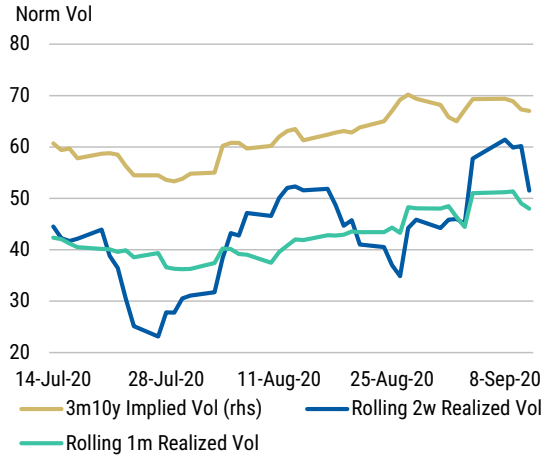


Source: Bloomberg, Morgan Stanley Research

The key takeaway from this exhibit is that at around late-July to early-Aug, ~3.5m prior to the election day, realized volatility tended to dip; whereas starting from early September, ~2m prior to the election day, realized volatility started to take off.

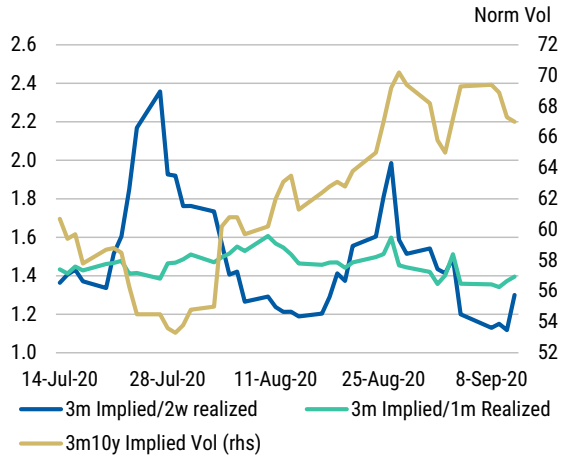
Two months prior to this year's election would have been September 3rd. And, as expected, we have seen realized vol begin to pick up. Exhibit 114 shows that on both a 1m and 2w rolling basis (2w rolling basis more so), realized vol on 3m10y swap rate has increased in the last week. We expect realized vol to continue to pick up heading into the election. We also think that markets are well aware that this election could be long drawn, so implied vol and realized vol could increase going into the election, and even after the election, perhaps more than in the past (see Exhibit 4 in United States | Exiting curve steepeners; Lower Treasury forecasts).

Exhibit 114: 3m10y implied vol vs 2w and 1m rolling realized vol on 3m10y swap rate



Source: Bloomberg, Morgan Stanley Research

Exhibit 115: 3m10y implied vol vs implied/realized ratios



Source: Bloomberg, Morgan Stanley Research

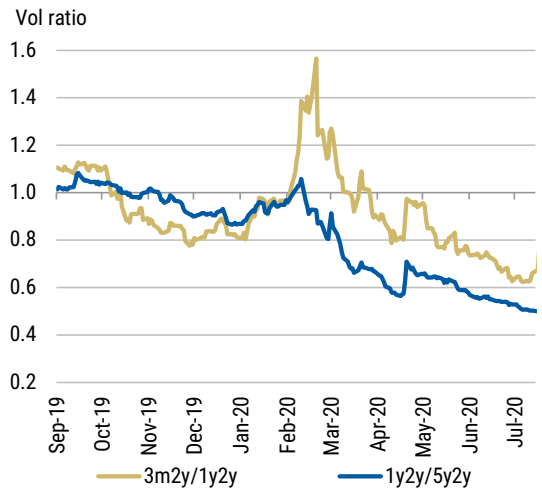
Alongside realized vol, 3m10y implied vol has also increased in the last couple of weeks, but the implied/realized ratio has fallen when using both a 1m and 2w rolling time horizon for realized vol. So, we still think there is value in owning gamma that covers the election date. As such, we continue to suggest 3m10y ATMF straddles, delta hedged.

Trade idea: Maintain 3m10y ATMF straddle, delta-hedged

Expiry and Tail Switch

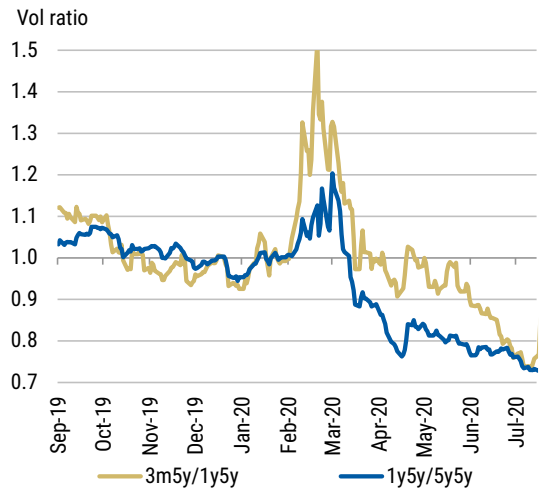
After retracing a bit earlier this summer, the expiry term structure in gamma and the intermediate space on short-end and belly rates continues to steepen, which is characteristic of a ZIRP-QE regime (see Exhibit 116 and Exhibit 117). It is worth noting that the 3m/1y term structure has retraced in the last month alone, primarily due to the fact that the 3m date now captures the election.

Exhibit 116: Expiry switch ratio: 2y tail



Source: Bloomberg, Morgan Stanley Research

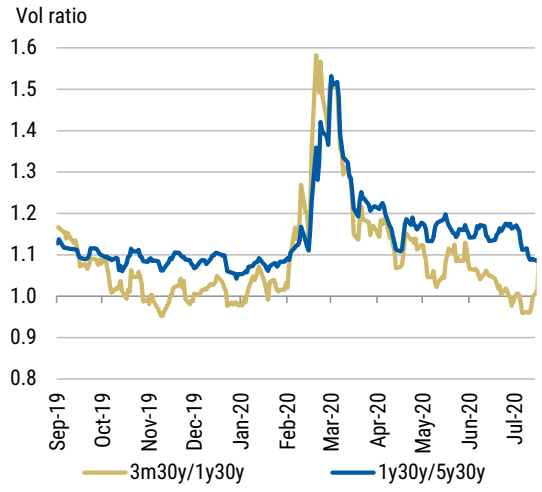
Exhibit 117: Expiry switch ratio: 5y tail



Source: Bloomberg, Morgan Stanley Research

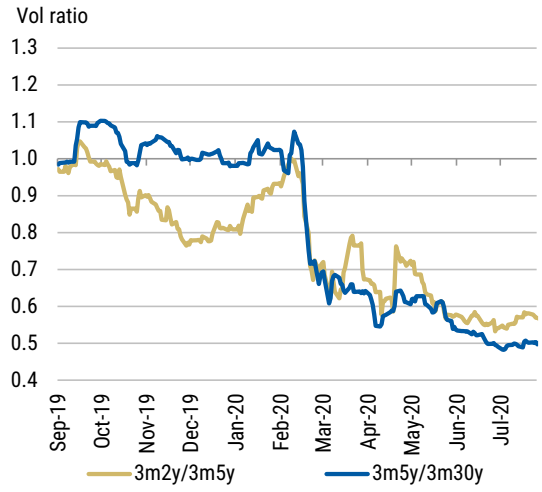
The expiry term structure in the long-end tails, however, remains relatively inverted. This inversion is likely driven by a combination of continued strong callable issuance in the last month, as well as continued interest in owning high-strikes on long-dated tails. The 3m/1y expiry term structure was briefly upward sloping as gamma reached cycle-lows in July, but given that the 3m point now covers the election, the 3m/1y expiry term structure has re-inverted.

Exhibit 118: Expiry switch ratio: 30y tail



Source: Bloomberg, Morgan Stanley Research

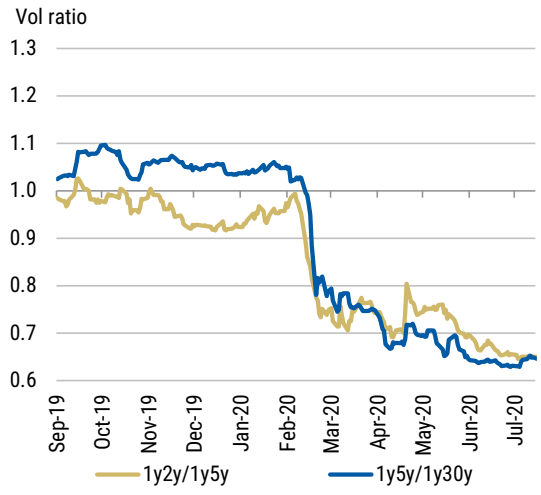
Exhibit 119: Tail switch ratio: 3m expiry



Source: Bloomberg, Morgan Stanley Research

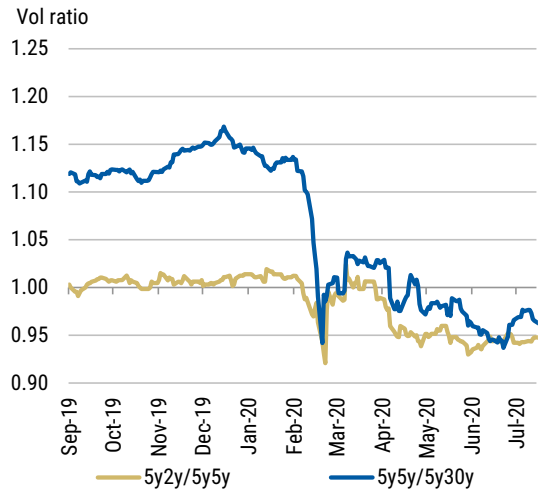
With respect to tail switches, the term structure has continued to steepen in gamma and intermediate expiries (with lower ratios in the exhibits equating to steeper term structures). As shown in Exhibit 119 and Exhibit 120, the left-hand side is trading at a 35-45% discount to the middle panel, which is then trading at another 50-65% discount to the right-hand side. The tail term structure on longer expiries remains largely flat, though the term structure has steepened modestly over the last couple months (see Exhibit 121).

Exhibit 120: Tail switch expiry: 1y expiry



Source: Bloomberg, Morgan Stanley Research

Exhibit 121: Tail switch expiry: 5y expiry



Source: Bloomberg, Morgan Stanley Research

Technical Analysis

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Pivot Points

Pivot points are charting levels used by day traders to determine market direction, support, and resistance levels. We calculate weekly pivot points using the previous week's open, high, low, and closing levels.

Exhibit 122: Government bond yield weekly pivots, support and resistance levels

	UST 10y	CAN 10y	DBR 10y	UKT 10y	JGB 20y	ACGB 10y
Weekly resistance 3	0.745	0.629	-0.386	0.334	0.449	1.008
Weekly resistance 2	0.721	0.606	-0.418	0.287	0.435	0.976
Weekly resistance 1	0.706	0.592	-0.438	0.258	0.426	0.957
Weekly pivot high	0.682	0.568	-0.470	0.211	0.413	0.926
Weekly pivot low	0.676	0.563	-0.480	0.199	0.410	0.917
Weekly Support 1	0.657	0.545	-0.502	0.164	0.399	0.894
Weekly Support 2	0.642	0.531	-0.522	0.135	0.390	0.875
Weekly Support 3	0.630	0.518	-0.536	0.112	0.383	0.861

Source: Morgan Stanley Research

Exhibit 123: Foreign exchange rates weekly pivots, support, and resistance levels

	DXY	EURUSD	USDJPY	GBPUSD	AUDUSD	USDCAD
Weekly resistance 3	94.17	1.2003	106.69	1.3463	0.7400	1.3374
Weekly resistance 2	93.94	1.1964	106.47	1.3266	0.7371	1.3325
Weekly resistance 1	93.80	1.1940	106.33	1.3144	0.7349	1.3293
Weekly pivot high	93.32	1.1858	106.11	1.2946	0.7282	1.3186
Weekly pivot low	93.20	1.1839	106.04	1.2901	0.7267	1.3162
Weekly Support 1	92.97	1.1800	105.89	1.2749	0.7238	1.3113
Weekly Support 2	92.84	1.1776	105.75	1.2627	0.7216	1.3081
Weekly Support 3	92.61	1.1737	105.69	1.2521	0.7185	1.3031

Source: Morgan Stanley Research

Exhibit 124: Foreign exchange rates weekly pivots, support, and resistance levels

	EURJPY	EURCHF	EURNOK	EURSEK	NOKSEK	AUDNZD
Weekly resistance 3	127.58	1.0885	10.9475	10.4749	0.9950	1.0997
Weekly resistance 2	126.80	1.0848	10.8869	10.4550	0.9864	1.0979
Weekly resistance 1	126.78	1.0825	10.8446	10.4372	0.9811	1.0960
Weekly pivot high	125.60	1.0788	10.7086	10.3862	0.9725	1.0910
Weekly pivot low	125.55	1.0779	10.6783	10.3762	0.9699	1.0901
Weekly Support 1	124.77	1.0751	10.6177	10.3563	0.9639	1.0883
Weekly Support 2	124.75	1.0728	10.5754	10.3385	0.9586	1.0864
Weekly Support 3	124.30	1.0710	10.5119	10.3152	0.9552	1.0841

Source: Morgan Stanley Research

Charting

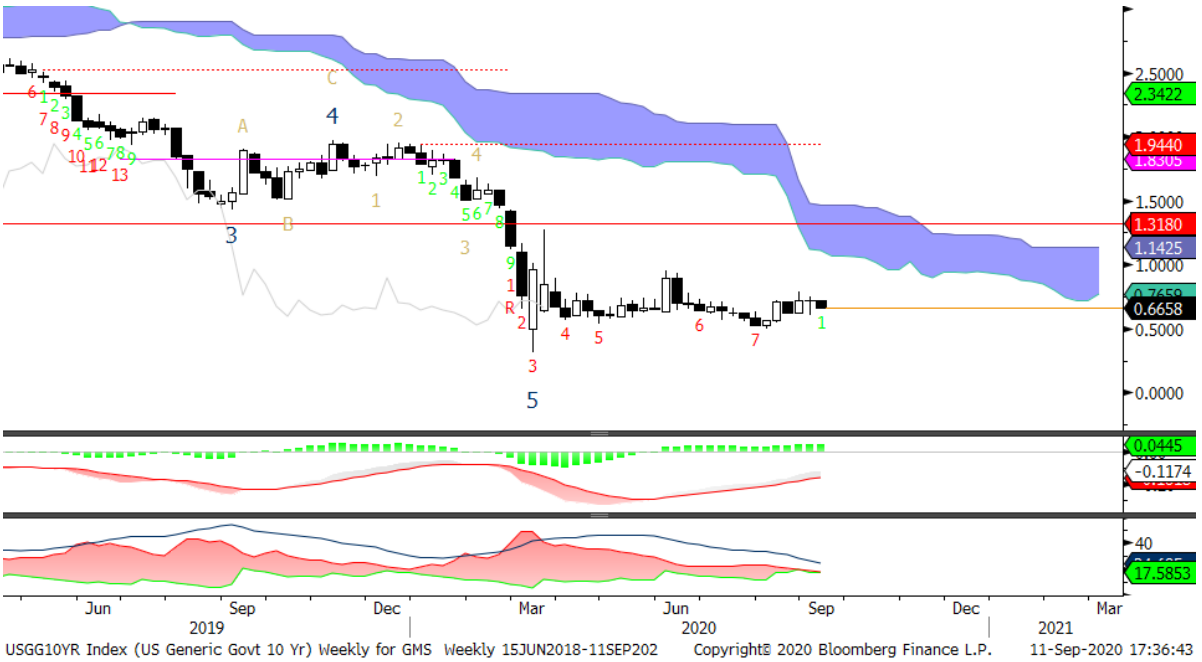
UST 10-year yield at 0.67%

Short term: mixed*, trend weak and weakening
Medium term: mixed*, trend weak and weakening
Support: 0.72/0.73%, 0.78%, 0.83%, 0.91%, 0.96%
Resistance: 0.62/0.63%, 0.57%, 0.50/0.51%, 0.40%, 0.31%

Exhibit 125: UST 10-year on-the-run yield - Daily

Source: Morgan Stanley Research, Bloomberg, * Bullish/bearish refers to price, not yield

Exhibit 126: UST 10-year on-the-run yield - Weekly



Source: Morgan Stanley Research, Bloomberg, * Bullish/bearish refers to price, not yield

DBR 10-year yield at -0.48%

Short term: mixed*, trend weak and stable
Medium term: bearish, trend weak and stable
Support: -0.42%, -0.38%, -0.33%, -0.30%, -0.26%
Resistance: -0.51/-0.52%, -0.55/-0.56%, -0.59%

Exhibit 127: DBR 10-year benchmark yield - Daily

Source: Morgan Stanley Research, Bloomberg, * Bullish/bearish refers to price, not yield

Exhibit 128: DBR 10-year benchmark yield - Weekly

Source: Morgan Stanley Research, Bloomberg

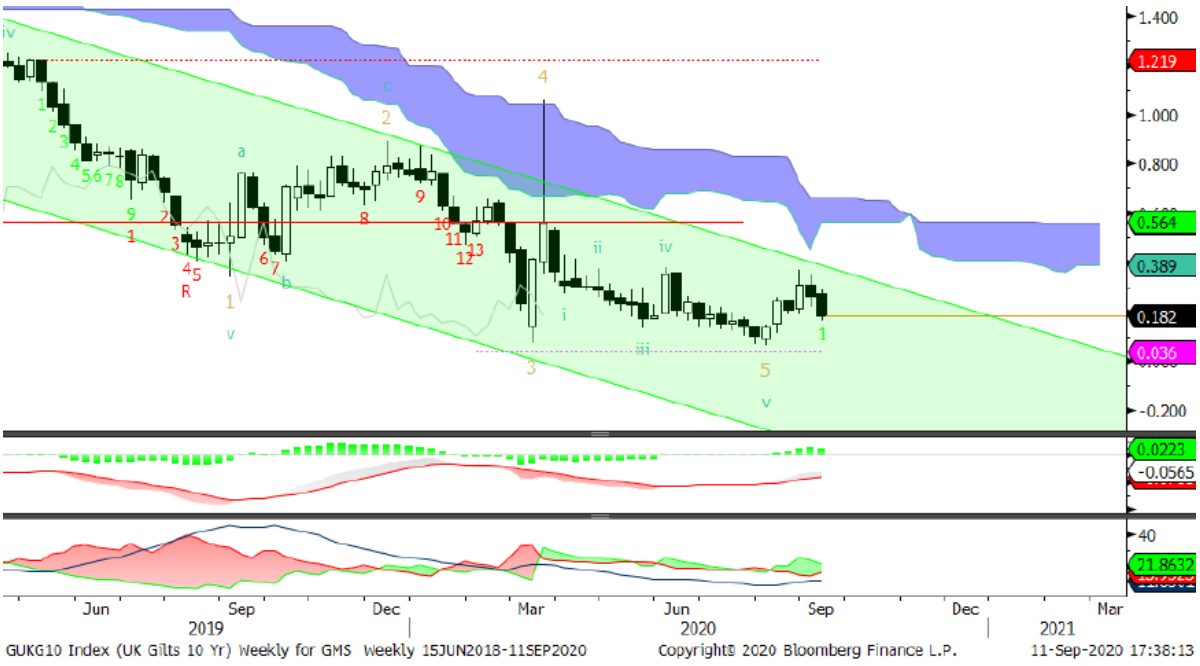
UKT 10-year yield at 0.18%

Short term: bullish*, trend weak and stable
Medium term: bullish, trend weak and stable
Support: 0.26%, 0.29%, 0.35%, 0.38%, 0.42%
Resistance: 0.17%, 0.14%, 0.09%, 0.06%

Exhibit 129: UKT 10-year benchmark yield - Daily

Source: Morgan Stanley Research, Bloomberg, * Bullish/bearish refers to price, not yield

Exhibit 130: UKT 10-year benchmark yield - Weekly

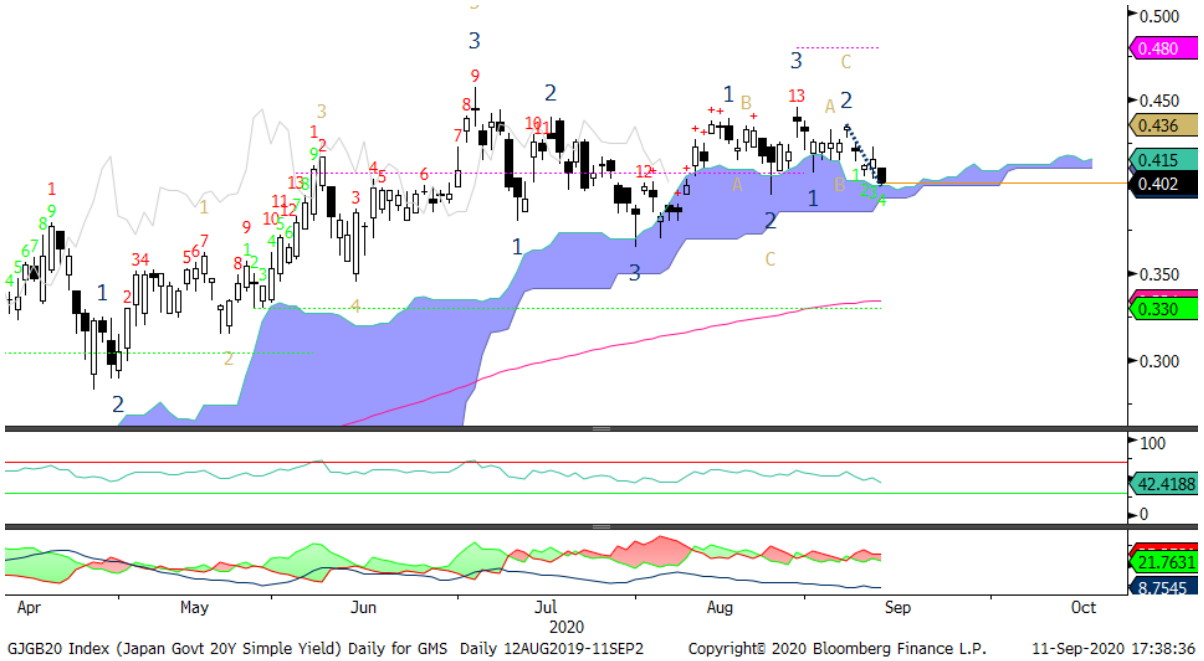


Source: Morgan Stanley Research, Bloomberg

JGB 20-year yield at 0.40%

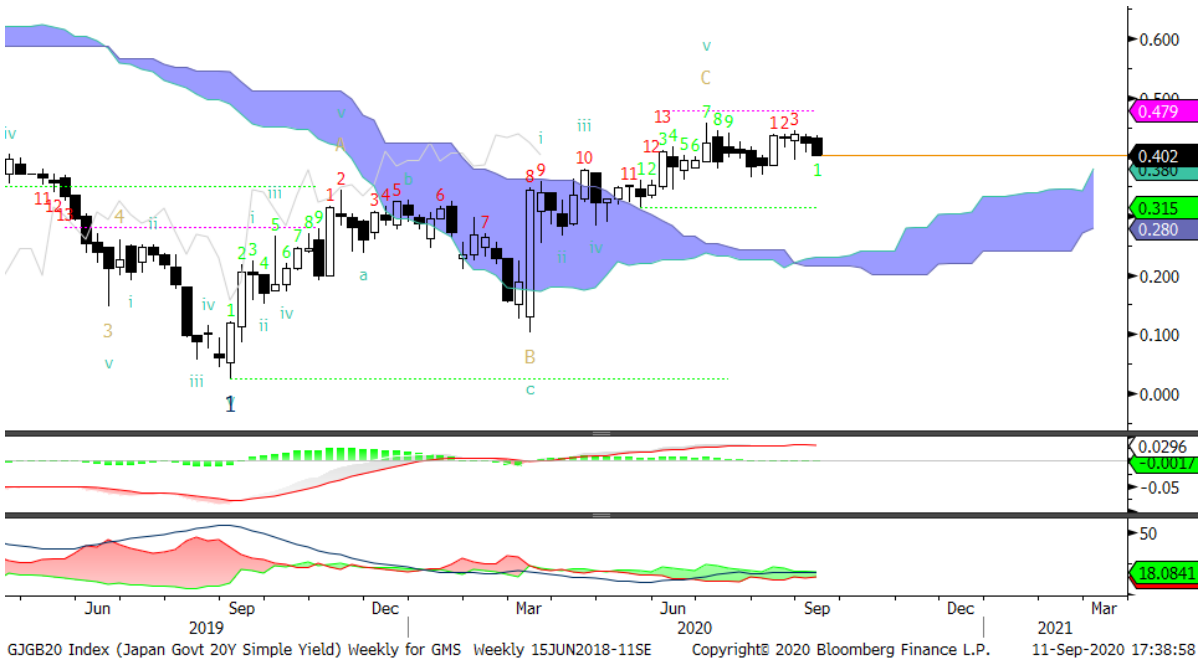
Short term: bullish*, trend weak and stable
Medium term: bearish, trend weak and stable
Support: 0.43/0.44%, 0.46%, 0.54%, 0.70%
Resistance: 0.40/0.41%, 0.36/0.37%, 0.33%

Exhibit 131: JGB 20-year benchmark yield - Daily



Source: Morgan Stanley Research, Bloomberg, * Bullish/bearish refers to price, not yield

Exhibit 132: JGB 20-year benchmark yield - Weekly

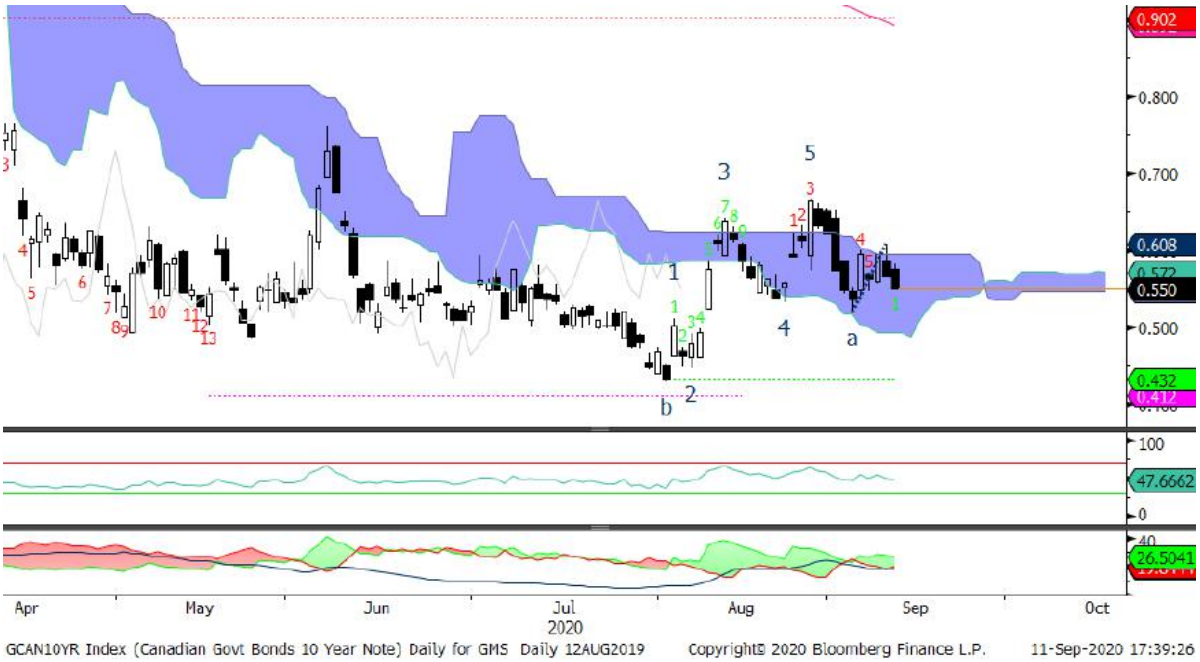


Source: Morgan Stanley Research, Bloomberg

CAN 10-year yield at 0.55%

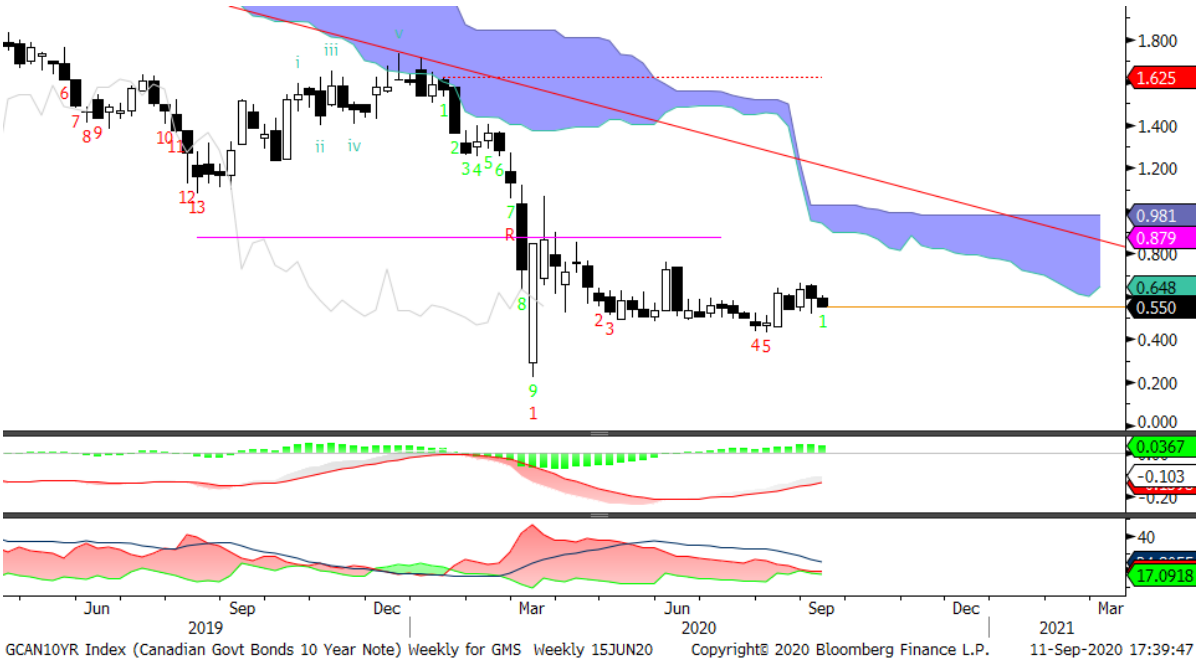
Short term: bearish*, trend weak and stable
Medium term: mixed, trend moderate, but weakening
Support: 0.65/0.67%, 0.75/0.76%, 0.85/0.86%
Resistance: 0.53%, 0.50%, 0.43/0.44%, 0.38%

Exhibit 133: CAN 10-year benchmark yield - Daily



Morgan Stanley Research, Bloomberg, * Bullish/bearish refers to price, not yield

Exhibit 134: CAN 10-year benchmark yield - Weekly



Morgan Stanley Research, Bloomberg

ACGB 10-year yield at 0.91%

Short term: bearish*, trend weak and stable
Medium term: bearish, trend moderate and strengthening
Support: 0.97%, 1.00/1.01%, 1.06%, 1.11%
Resistance: 0.88%, 0.82%, 0.80%, 0.75/0.76%

Exhibit 135: ACGB 10-year benchmark yield - Daily

Morgan Stanley Research, Bloomberg, * Bullish/bearish refers to price, not yield

Exhibit 136: ACGB 10-year benchmark yield - Weekly

Morgan Stanley Research, Bloomberg

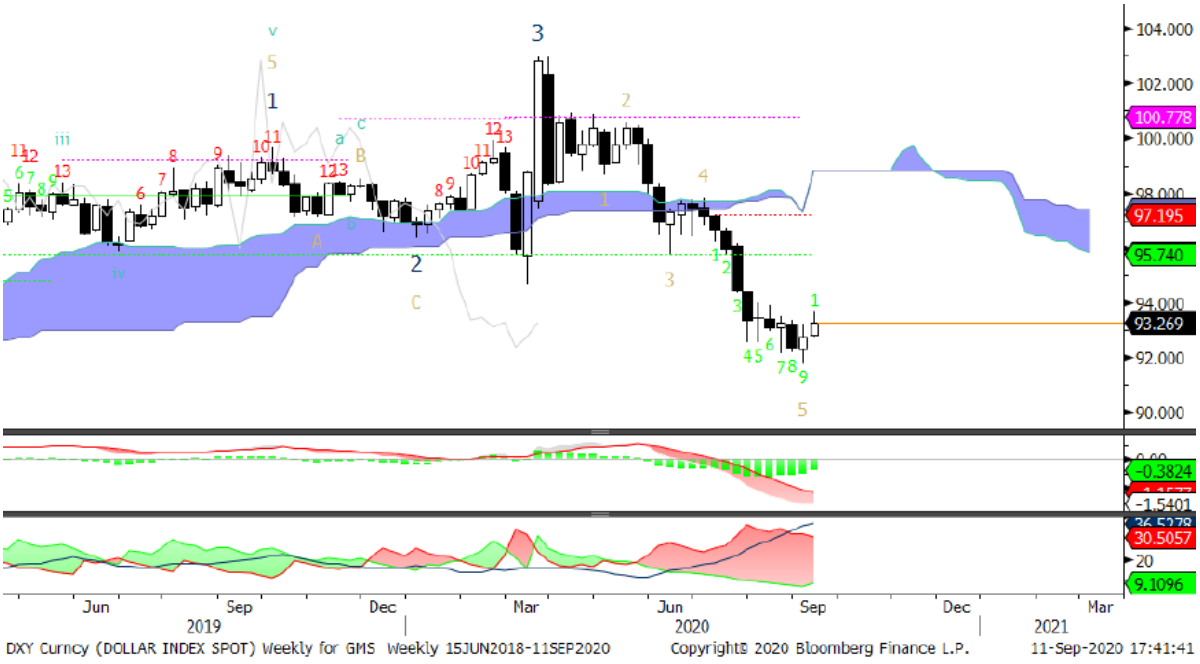
DXY index at 93.25

Short term: mixed, trend moderate, but weakening
Medium term: bearish, trend strong and strengthening
Support: 92.75, 91.75, 89.50, 89.00, 88.25
Resistance: 93.75/94.00, 95.00, 95.75, 96.25

Exhibit 137: DXY index - Daily

Source: Morgan Stanley Research, Bloomberg

Exhibit 138: DXY index - Weekly

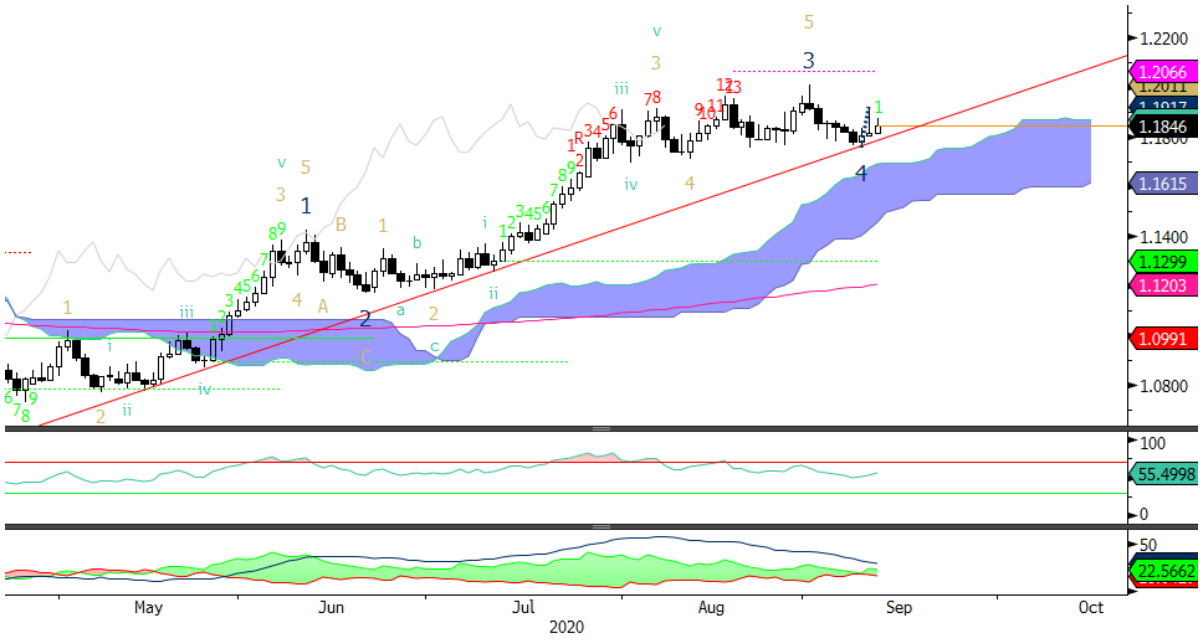


Source: Morgan Stanley Research, Bloomberg

EUR/USD exchange rate at 1.1846

Short term: bullish, trend moderate, but weakening
Medium term: bullish, trend strong and strengthening
Support: 1.1750/60, 1.1600, 1.1475, 1.1375, 1.1250/60
Resistance: 1.1900, 1.2000, 1.2225, 1.2400, 1.2500

Exhibit 139: EUR/USD exchange rate - Daily



Source: Morgan Stanley Research, Bloomberg

Exhibit 140: EUR/USD exchange rate - Weekly

Source: Morgan Stanley Research, Bloomberg

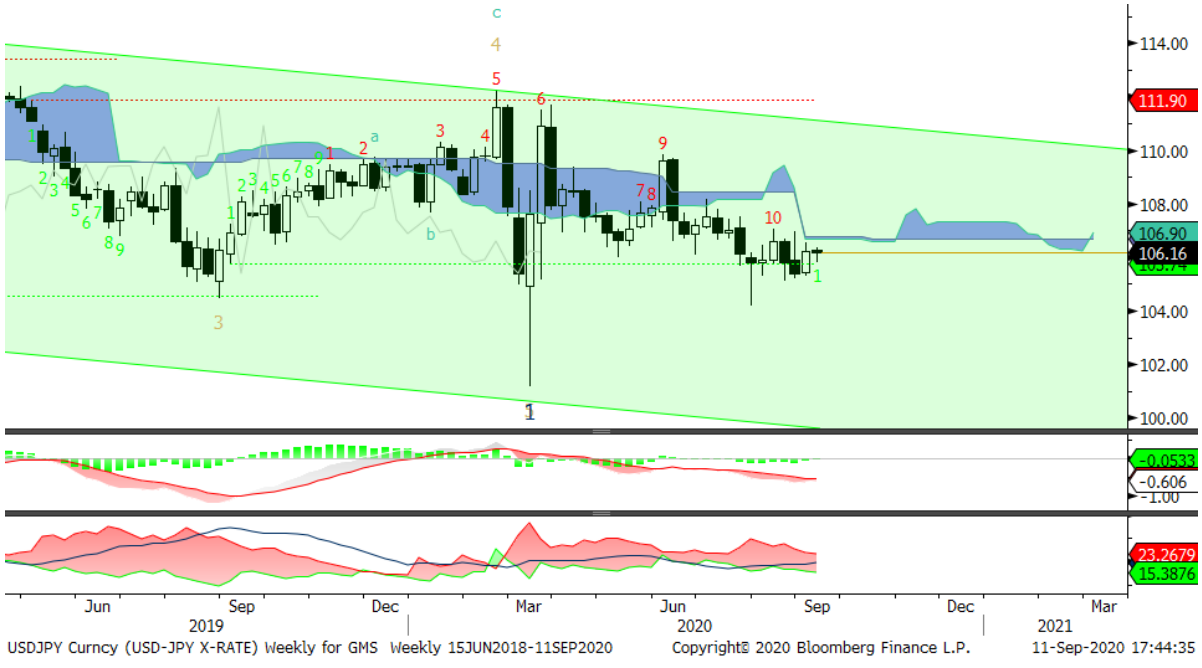
USD/JPY exchange rate at 106.16

Short term: bearish, trend weak and stable
Medium term: bearish, trend weak and stable
Support: 105.80, 105.25, 104.25, 103.50, 103.00
Resistance: 106.50, 107.00. 107.40/50, 108.00/20

Exhibit 141: USD/JPY exchange rate - Daily

Source: Morgan Stanley Research, Bloomberg

Exhibit 142: USD/JPY exchange rate - Weekly

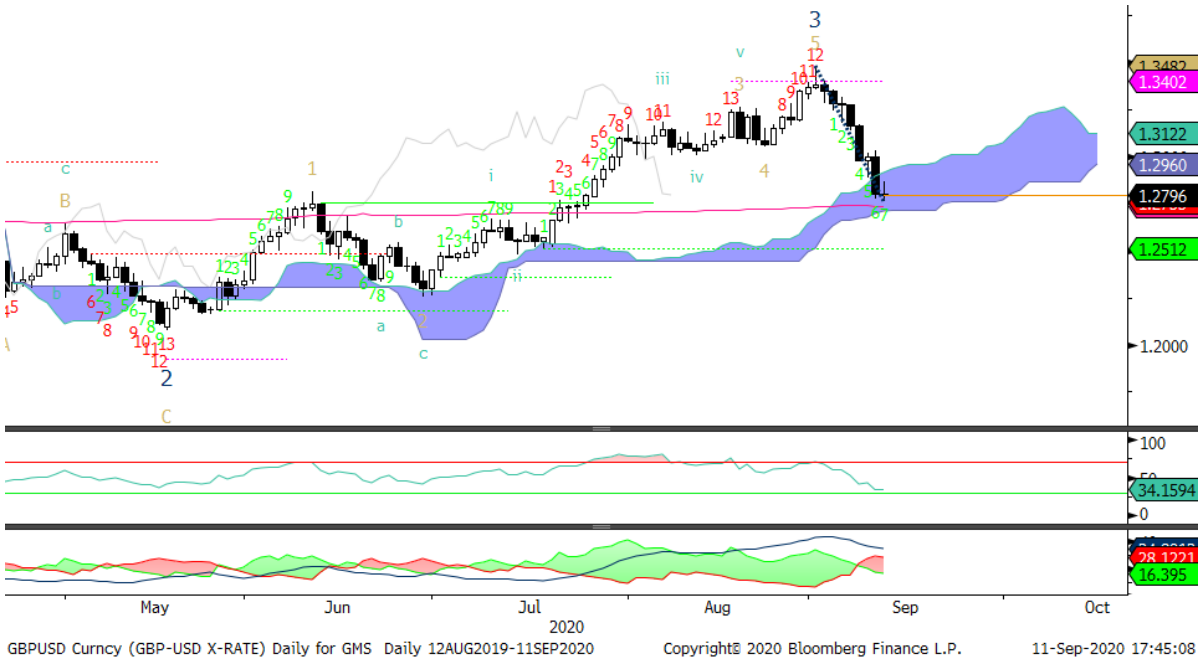


Source: Morgan Stanley Research, Bloomberg

GBP/USD exchange rate at 1.2796

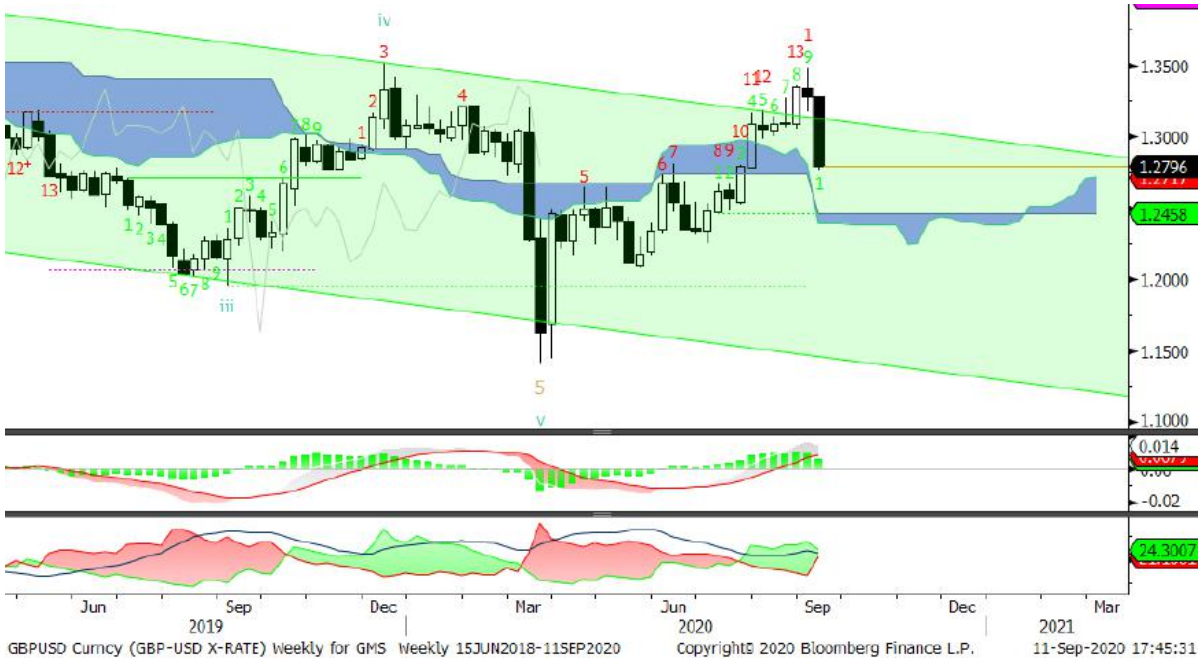
Short term: bearish, trend moderate, but weakening
Medium term: bullish, trend moderate, but weakening
Support: 1.2750, 1.2650, 1.2500, 1.2450, 1.2250
Resistance: 1.2900, 1.3050, 1.3150, 1.3200, 1.3300

Exhibit 143: GBP/USD exchange rate - Daily



Source: Morgan Stanley Research, Bloomberg

Exhibit 144: GBP/USD exchange rate - Weekly

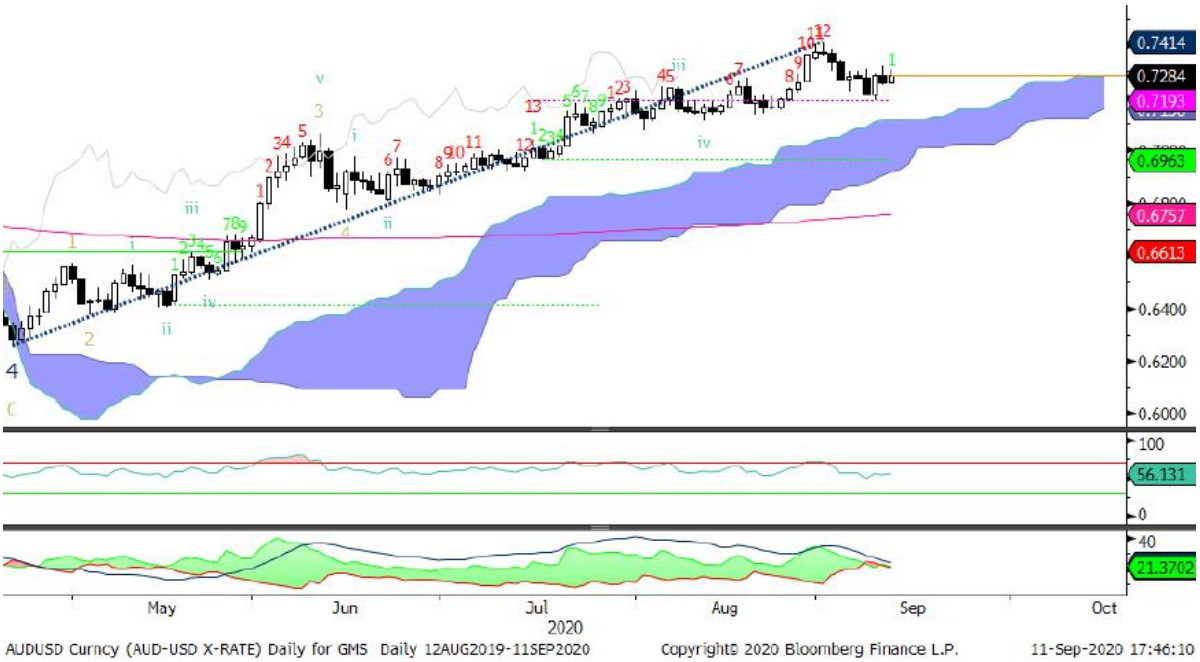


Source: Morgan Stanley Research, Bloomberg

AUD/USD exchange rate at 0.7284

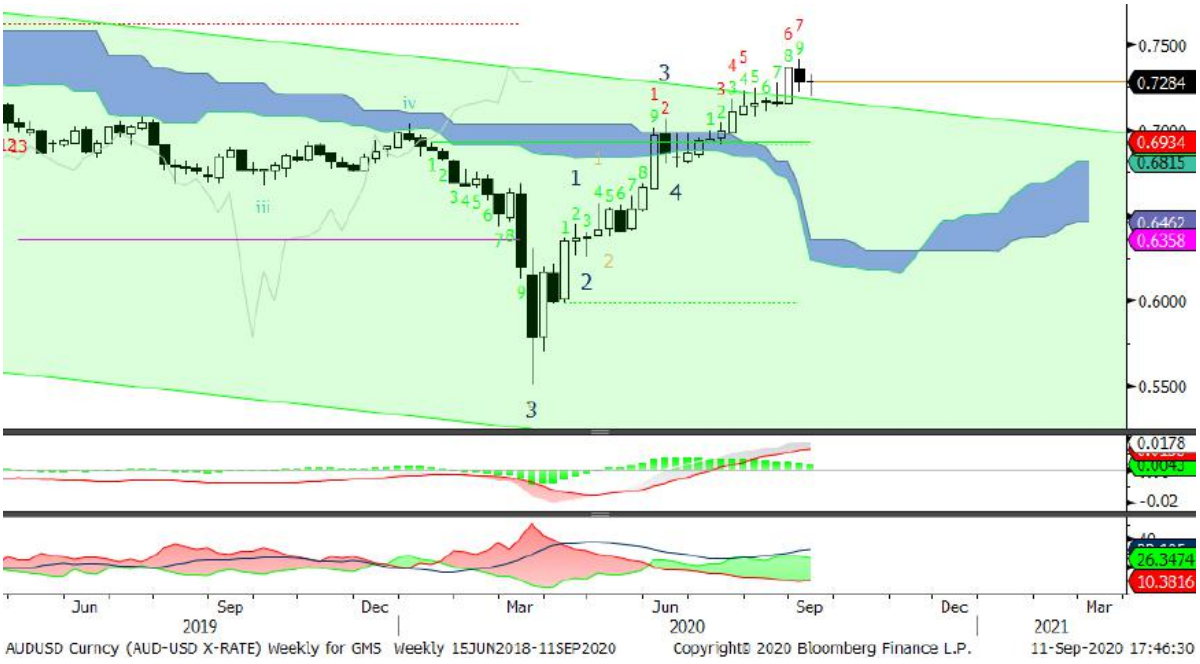
Short term: mixed, trend weak and weakening
Medium term: bullish, trend moderate and strengthening
Support: 0.7200, 0.7150, 0.7025, 0.6925, 0.6850
Resistance: 0.7300, 0.7400, 0.7625/75, 0.7800

Exhibit 145: AUD/USD exchange rate - Daily



Source: Morgan Stanley Research, Bloomberg

Exhibit 146: AUD/USD exchange rate - Weekly



Source: Morgan Stanley Research, Bloomberg

USD/CAD exchange rate at 1.3179

Short term: mixed, trend moderate, but weakening
Medium term: bearish, trend moderate and stable
Support: 1.3150, 1.3050, 1.3000, 1.2950, 1.2800
Resistance: 1.3250, 1.3350, 1.3400, 1.3450, 1.3500

Exhibit 147: USD/CAD exchange rate - Daily

Source: Morgan Stanley Research, Bloomberg

Exhibit 148: USD/CAD exchange rate - Weekly

Source: Morgan Stanley Research, Bloomberg

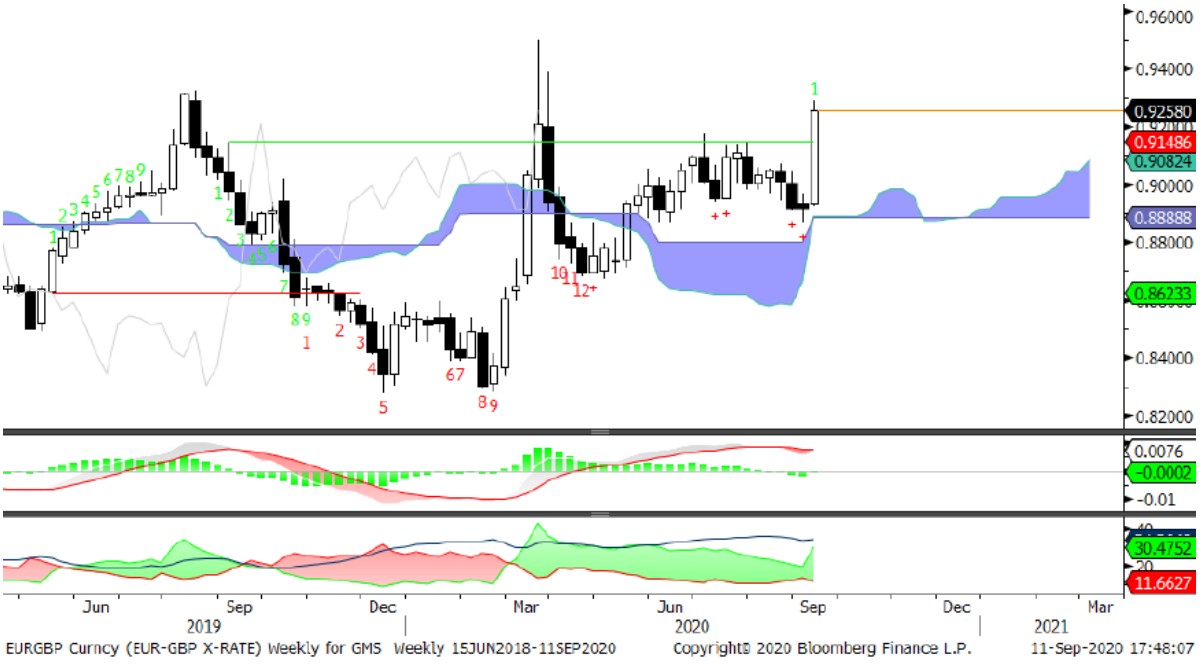
EUR/GBP exchange rate at 0.9258

Short term: bullish, trend moderate and strengthening
Medium term: bullish, trend strong and strengthening
Support: 0.9150, 0.9050, 0.9000, 0.8940/50
Resistance: 0.9325/50, 0.9400/15, 0.9500, 0.9800

Exhibit 149: EUR/GBP exchange rate - Daily

Source: Morgan Stanley Research, Bloomberg

Exhibit 150: EUR/GBP exchange rate - Weekly



Source: Morgan Stanley Research, Bloomberg

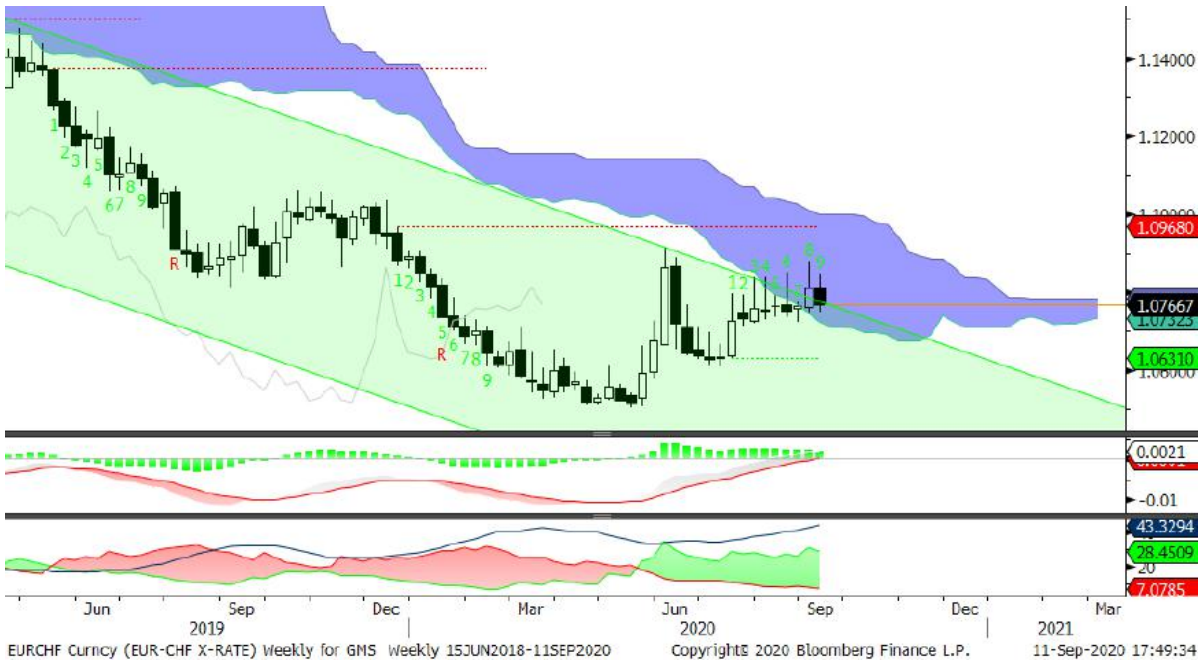
EUR/CHF exchange rate at 1.0767

Short term: bullish, trend strong, but weakening
Medium term: bullish, trend strong and strengthening
Support: 1.0750, 1.0725, 1.0610/25, 1.0580, 1.0515
Resistance: 1.0840/50, 1.0875, 1.0900, 1.1000

Exhibit 151: EUR/CHF exchange rate - Daily

Source: Morgan Stanley Research, Bloomberg

Exhibit 152: EUR/CHF exchange rate - Weekly

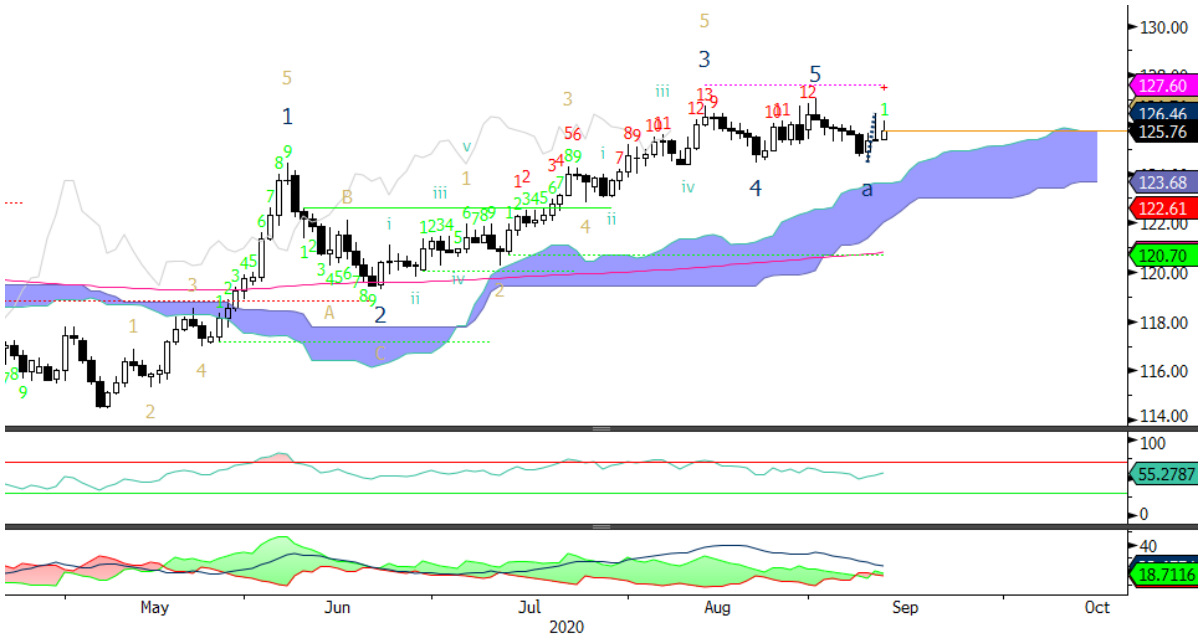


Source: Morgan Stanley Research, Bloomberg

EUR/JPY exchange rate at 125.76

Short term: mixed, trend weak and weakening
Medium term: bullish, trend strong and strengthening
Support: 124.50, 123.00, 122.50, 122.00, 121.50
Resistance: 126.50, 127.00, 127.50, 129.25/50

Exhibit 153: EUR/JPY exchange rate - Daily



Source: Morgan Stanley Research, Bloomberg

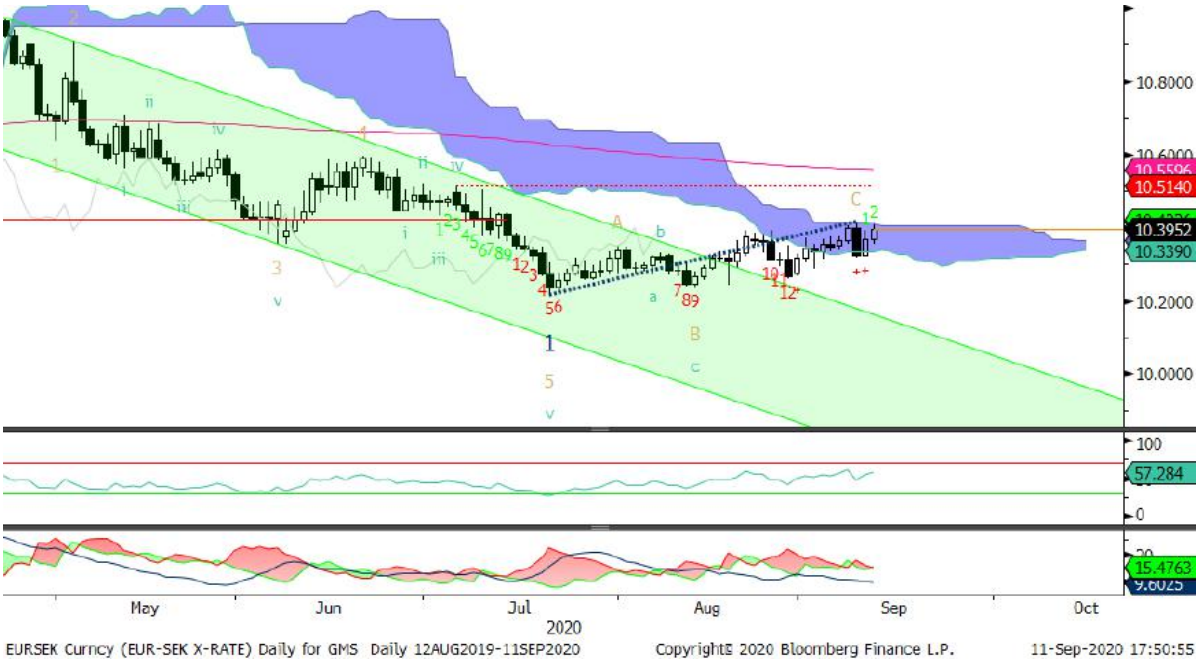
Exhibit 154: EUR/JPY exchange rate - Weekly

Source: Morgan Stanley Research, Bloomberg

EUR/SEK exchange rate at 10.39

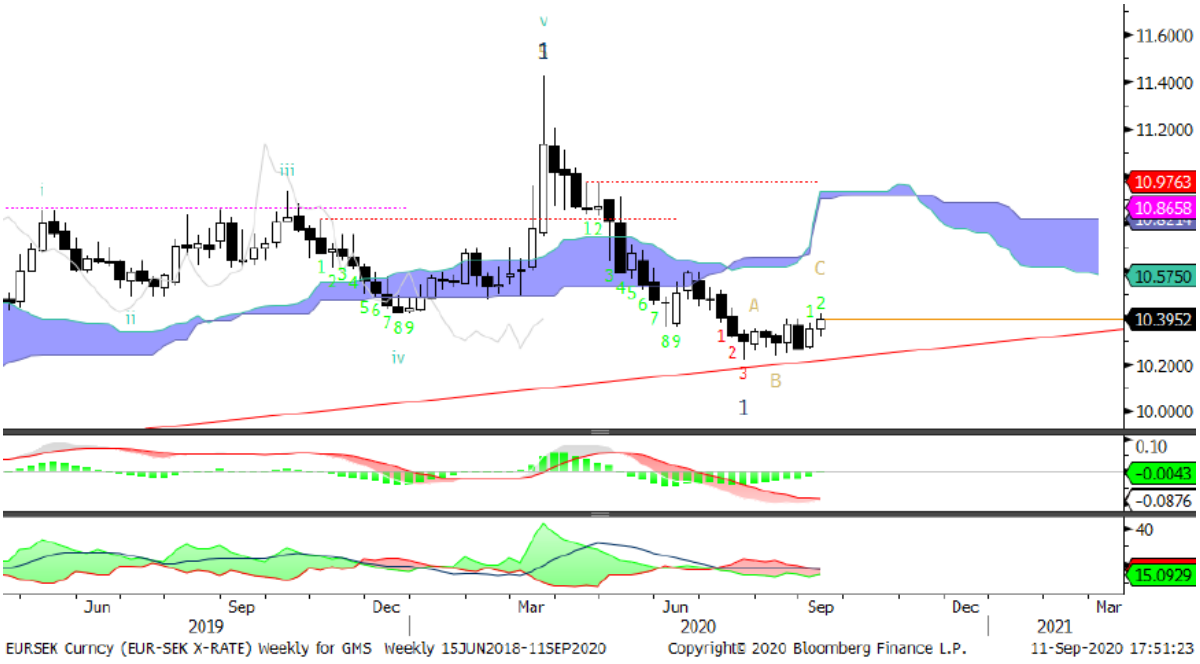
Short term: mixed, trend weak and weakening
Medium term: bullish, trend strong, but weakening
Support: 10.32, 10.29, 10.26, 10.24, 10.22
Resistance: 10.40, 10.44/45, 10.50, 10.60

Exhibit 155: EUR/SEK exchange rate - Daily



Source: Morgan Stanley Research, Bloomberg

Exhibit 156: EUR/SEK exchange rate - Weekly



Source: Morgan Stanley Research, Bloomberg

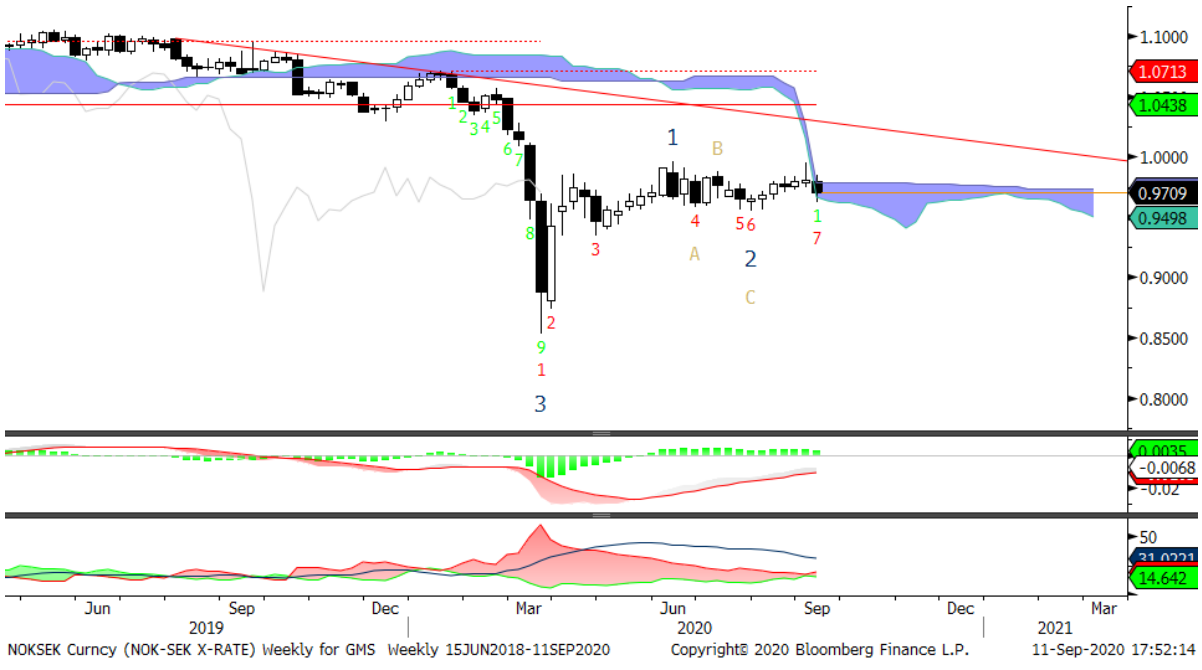
NOK/SEK exchange rate at 0.9709

Short term: bearish, trend weak and weakening
Medium term: bearish, trend moderate, but weakening
Support: 0.9650, 0.9550, 0.9500, 0.9450, 0.9350
Resistance: 0.9800, 0.9925, 0.9950/60, 100.00/10

Exhibit 157: NOK/SEK exchange rate - Daily

Source: Morgan Stanley Research, Bloomberg

Exhibit 158: NOK/SEK exchange rate - Weekly

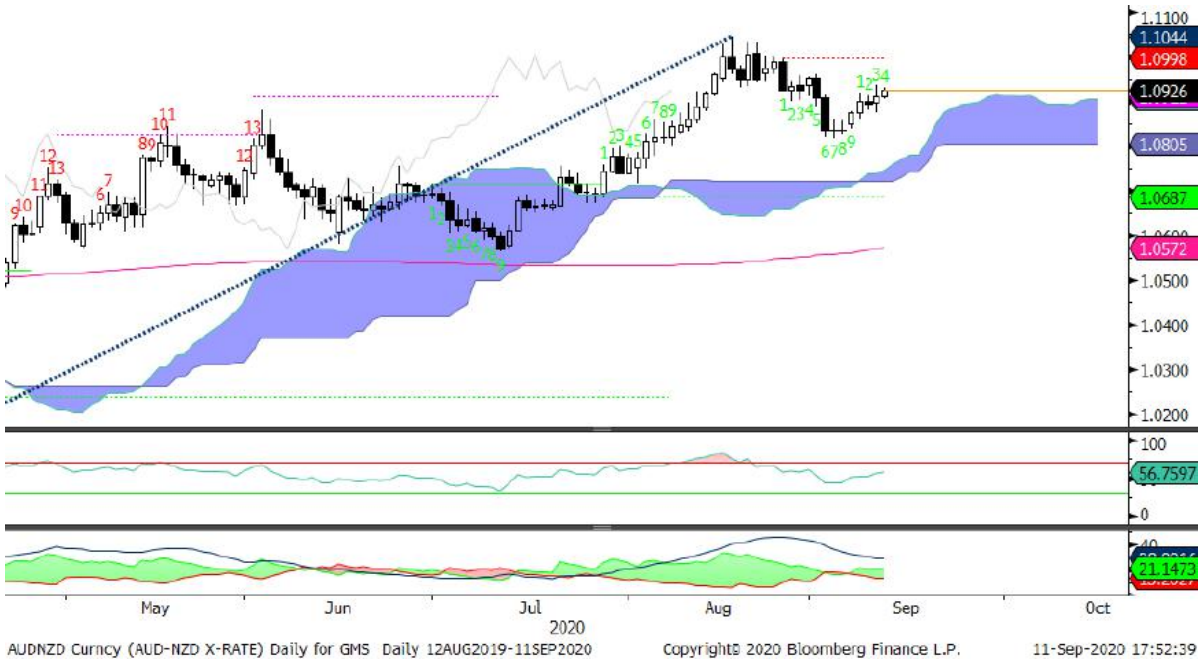


Source: Morgan Stanley Research, Bloomberg

AUD/NZD exchange rate at 1.0926

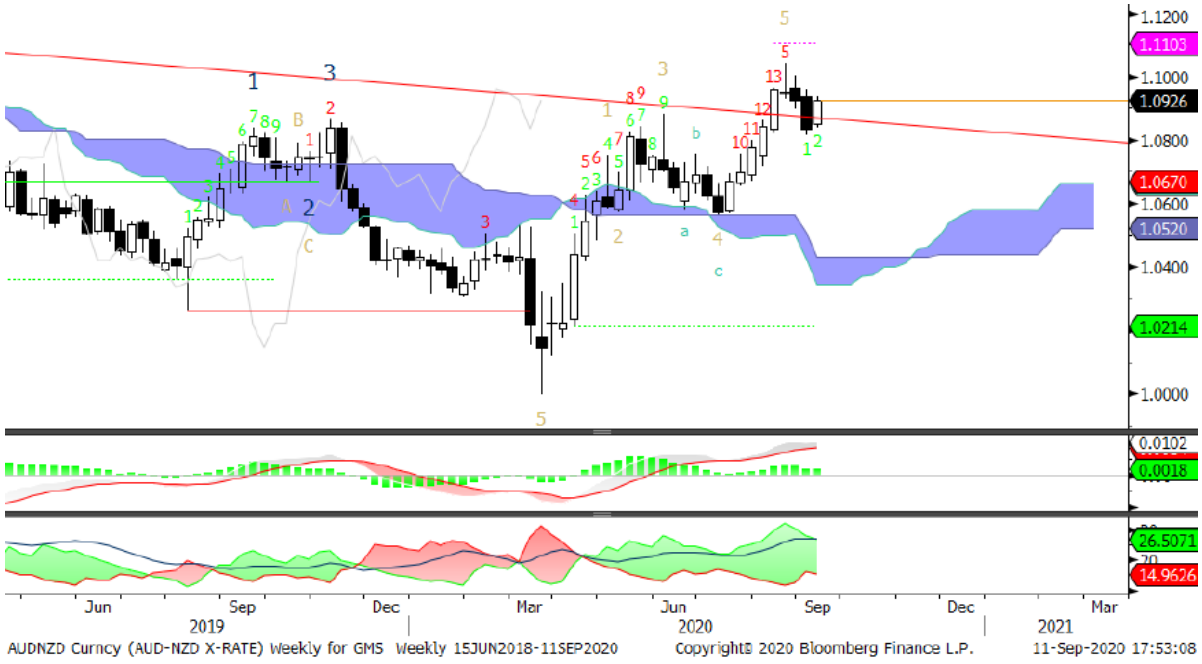
Short term: bullish, trend moderate, but weakening
Medium term: bullish, trend strong and stable
Support: 1.0825/50, 1.0750, 1.0650/75, 1.0575
Resistance: 1.0950, 1.1000, 1.1175, 1.1290, 1.1325/50

Exhibit 159: AUD/NZD exchange rate - Daily



Source: Morgan Stanley Research, Bloomberg

Exhibit 160: AUD/NZD exchange rate - Weekly

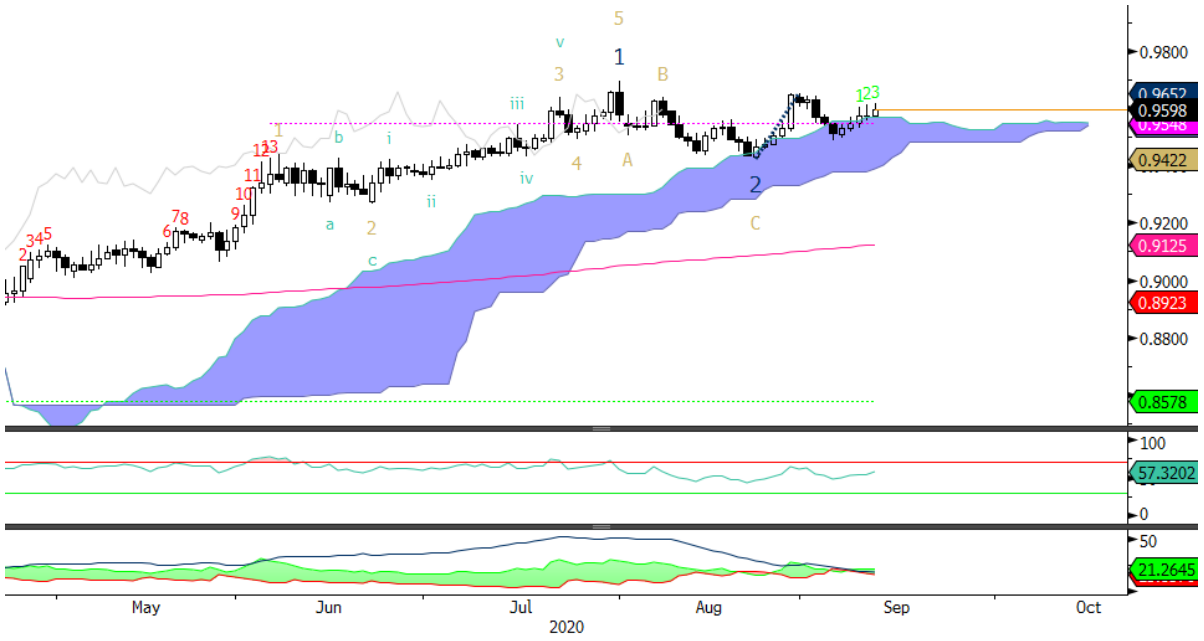


Source: Morgan Stanley Research, Bloomberg

AUD/CAD exchange rate at 0.9598

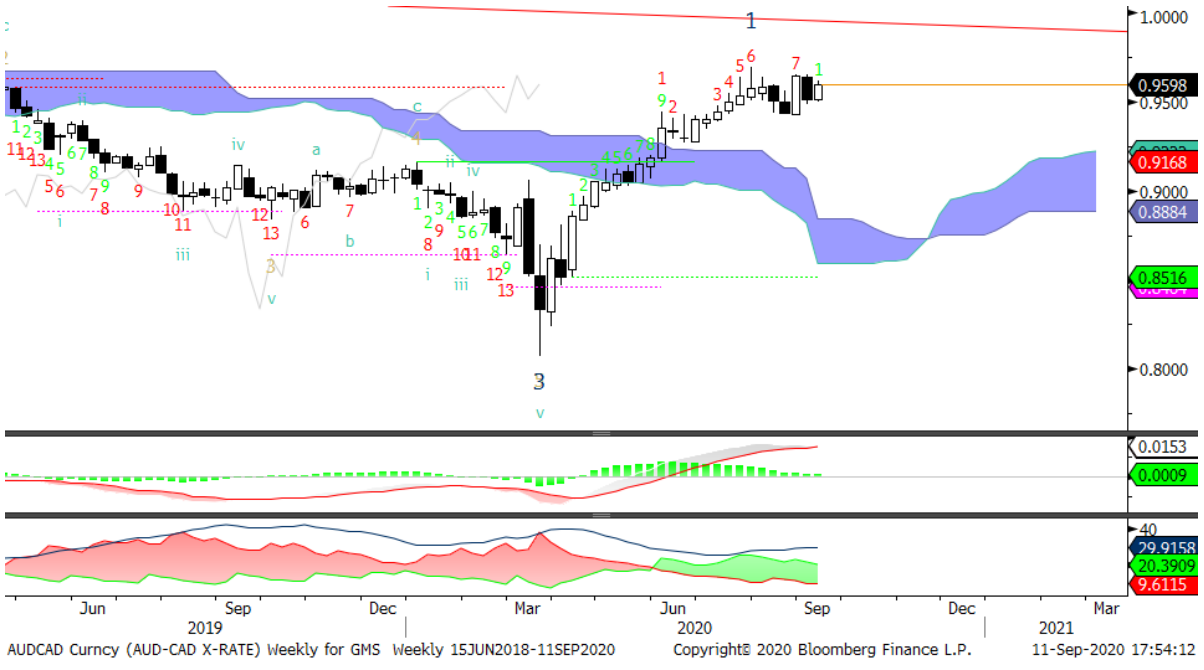
Short term: bullish, trend weak and weakening
Medium term: bullish, trend moderate and strengthening
Support: 0.9550, 0.9500, 0.9400, 0.9350
Resistance: 0.9650, 0.9700, 0.9775/90, 98.75

Exhibit 161: AUD/CAD exchange rate - Daily



Source: Morgan Stanley Research, Bloomberg

Exhibit 162: AUD/CAD exchange rate - Weekly

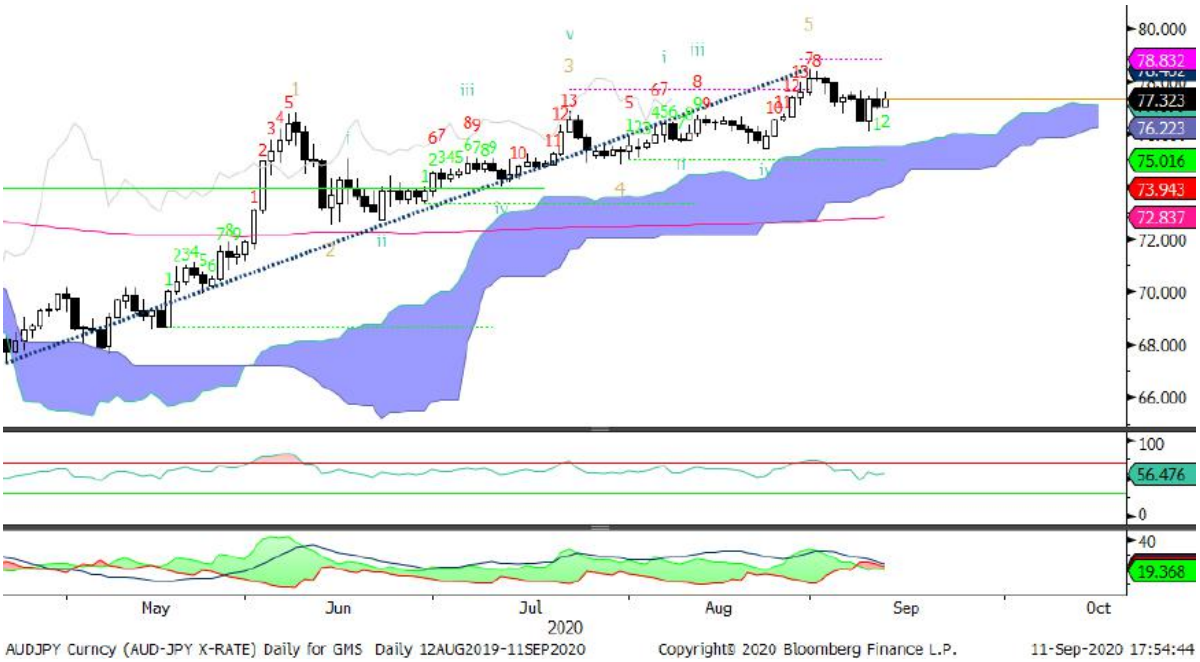


Source: Morgan Stanley Research, Bloomberg

AUD/JPY exchange rate at 77.32

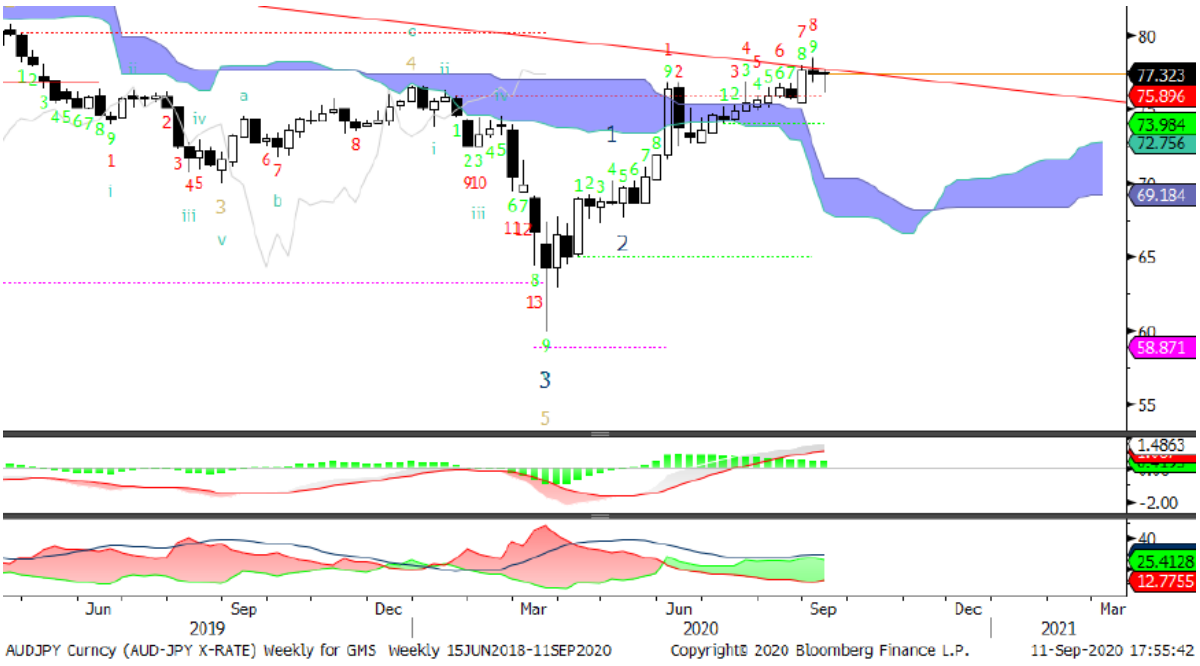
Short term: bearish, trend weak and weakening
Medium term: bullish, trend moderate and stable
Support: 76.50, 76.00, 75.00, 74.00, 73.00
Resistance: 77.50, 78.25, 80.00, 84.00, 89.00

Exhibit 163: AUD/JPY exchange rate - Daily



Source: Morgan Stanley Research, Bloomberg

Exhibit 164: AUD/JPY exchange rate - Weekly



Source: Morgan Stanley Research, Bloomberg

Cyclical and Secular Trends

Government Bonds

In The Tactical Bull Market Is Back, we discussed a simple methodology based on the Ichimoku Kinko charting technique for classifying market movements as bullish, bearish, or range bound. Then, we define whether the market movement is cyclical or secular in nature. A cyclical move is shorter term in nature, and a secular move is longer term in nature. For cyclical moves, we further divide them into tactical and strategic. We use daily data to inform tactical moves, and weekly data to inform strategic moves. We use monthly data to inform secular movements.

Exhibit 165: Summary of cyclical (tactical and strategic) and secular bull, bear, and range bound rates markets

	Daily Last	Daily Cloud Lower	Daily Cloud Upper	200d MA	Cyclical Tactical Daily	Cyclical Strategic Weekly	Secular Monthly
UST 2y	0.127	0.134	0.170	0.596	Bull Market	Bull Market	Bull Market
UST 5y	0.252	0.249	0.346	0.712	Range bound	Bull Market	Bull Market
UST 10y	0.666	0.587	0.729	1.000	Range bound	Bull Market	Bull Market
UST 30y	1.412	1.273	1.461	1.615	Range bound	Bull Market	Bull Market
DBR 2y	-0.693	-0.683	-0.655	-0.675	Bull Market	Bear Market	Range bound
DBR 5y	-0.689	-0.683	-0.634	-0.637	Bull Market	Range bound	Bull Market
DBR 10y	-0.481	-0.485	-0.410	-0.420	Range bound	Range bound	Bull Market
DBR 30y	-0.037	-0.063	0.063	0.036	Range bound	Range bound	Bull Market
UKT 2y	-0.126	-0.075	-0.046	0.156	Bull Market	Bull Market	Bull Market
UKT 5y	-0.123	-0.097	-0.021	0.187	Bull Market	Bull Market	Bull Market
UKT 10y	0.182	0.124	0.221	0.379	Range bound	Bull Market	Bull Market
UKT 30y	0.749	0.643	0.676	0.846	Bear Market	Bull Market	Bull Market
JGB 10y	0.027	0.025	0.028	0.002	Range bound	Bear Market	Range bound
JGB 20y	0.402	0.394	0.401	0.338	Bear Market	Bear Market	Bull Market
JGB 30y	0.585	0.563	0.564	0.483	Bear Market	Bear Market	Bull Market
JGB 40y	0.610	0.596	0.601	0.503	Bear Market	Bear Market	Bull Market
ACGB 2y	0.217	0.264	0.271	0.421	Bull Market	Bull Market	Bull Market
ACGB 5y	0.379	0.392	0.399	0.522	Bull Market	Bull Market	Bull Market
ACGB 10y	0.911	0.870	0.954	0.965	Range bound	Bull Market	Bull Market
ACGB 20y	1.632	1.610	1.692	1.620	Range bound	Range bound	Bull Market
NZGB 2y	-0.010	0.256	0.315	0.510	Bull Market	Bull Market	Bull Market
NZGB 5y	0.024	0.374	0.381	0.661	Bull Market	Bull Market	Bull Market
NZGB 10y	0.602	0.817	0.831	1.055	Bull Market	Bull Market	Bull Market
CAN 2y	0.264	0.276	0.311	0.718	Bull Market	Bull Market	Bull Market
CAN 5y	0.356	0.342	0.420	0.763	Range bound	Bull Market	Bull Market
CAN 10y	0.550	0.494	0.596	0.870	Range bound	Bull Market	Bull Market
CAN 30y	1.060	0.966	1.118	1.261	Range bound	Bull Market	Bull Market

Source: Morgan Stanley Research

Exhibit 166: Summary of cyclical (tactical and strategic) and secular bull, bear, and range bound FX markets

	Daily Last	Daily Cloud Lower	Daily Cloud Upper	200d MA	Cyclical Tactical Daily	Cyclical Strategic Weekly	Secular Monthly
DXY	93.25	94.20	95.93	97.30	Bear Market	Bear Market	Range bound
USDJPY	106.16	105.66	107.02	107.84	Range bound	Bear Market	Bear Market
USDCAD	1.3179	1.3394	1.3534	1.3520	Bear Market	Bear Market	Bull Market
USDCHF	0.9089	0.9203	0.9390	0.9551	Bear Market	Bear Market	Range bound
USDNOK	9.0371	9.1415	9.4249	9.5167	Bear Market	Bear Market	Bull Market
USDSEK	8.7761	8.8627	9.1431	9.4374	Bear Market	Bear Market	Bull Market
EURUSD	1.1846	1.1425	1.1673	1.1203	Bull Market	Bull Market	Range bound
GBPUSD	1.2796	1.2696	1.2898	1.2737	Range bound	Range bound	Bear Market
AUDUSD	0.7284	0.6905	0.7115	0.6757	Bull Market	Bull Market	Bear Market
NZDUSD	0.6666	0.6433	0.6618	0.6390	Bull Market	Bull Market	Bear Market
EURJPY	125.76	121.65	123.61	120.78	Bull Market	Bull Market	Bear Market
NOKSEK	0.9709	0.9673	0.9757	0.9936	Range bound	Bear Market	Bear Market
AUDNZD	1.0926	1.0724	1.0741	1.0572	Bull Market	Bull Market	Bull Market
USDBRL	5.3196	5.1740	5.2628	4.9392	Bull Market	Bull Market	Bull Market
USDMXN	21.28	22.35	22.38	21.57	Bear Market	Bull Market	Bull Market
USDARS	74.91	70.24	71.82	65.92	Bull Market	Bull Market	Bull Market
USDCLP	768.84	777.20	788.24	799.74	Bear Market	Range bound	Bull Market
USDCOP	3,715.93	3,701.80	3,710.93	3,651.54	Bull Market	Bull Market	Bull Market
USDPEN	3.5750	3.4686	3.5244	3.4406	Bull Market	Bull Market	Bull Market
USDZAR	16.74	17.00	17.01	16.54	Bear Market	Bull Market	Bull Market
USDTRY	7.4761	6.9993	7.0671	6.6080	Bull Market	Bull Market	Bull Market
USDILS	3.4631	3.4209	3.4577	3.4779	Bull Market	Bear Market	Bear Market
USDRUB	75.22	71.32	72.71	69.73	Bull Market	Bull Market	Bull Market
USDPLN	3.7555	3.7875	3.8735	3.9357	Bear Market	Bear Market	Bull Market
USDCZK	22.4352	22.5594	23.3460	23.4847	Bear Market	Bear Market	Bear Market
USDHUF	301.62	297.90	304.19	308.80	Range bound	Range bound	Bull Market
USDCNY	6.8344	6.9883	7.0569	7.0102	Bear Market	Bear Market	Bull Market
USDIDR	14,890.00	14,388.00	14,539.25	14,491.17	Bull Market	Bull Market	Bull Market
USDINR	73.54	74.97	75.42	73.80	Bear Market	Bull Market	Bull Market
USDKRW	1,186.90	1,196.04	1,214.58	1,199.58	Bear Market	Range bound	Bull Market
USDMYR	4.1515	4.2468	4.2896	4.2277	Bear Market	Bear Market	Bull Market
USDPHP	48.55	49.39	49.93	50.25	Bear Market	Bear Market	Range bound
USDSGD	1.3678	1.3787	1.3945	1.3889	Bear Market	Bear Market	Bull Market
USDTWD	29.3840	29.3755	29.6940	29.9191	Range bound	Bear Market	Bear Market
USDTHB	31.3250	31.4258	31.4365	31.3275	Bear Market	Bull Market	Bear Market
GOLD	1,941	1,870	1,949	1,704	Range bound	Bull Market	Bull Market
SILVER	26.73	22.97	24.56	18.70	Bull Market	Bull Market	Bull Market
CRUDE OIL	37.39	38.01	41.34	42.49	Bear Market	Bear Market	Bear Market

Source: Morgan Stanley Research, Bloomberg

G4 Smarter (beta) Trading Strategy

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Enhancements to a G4 10y government bond futures momentum strategy have produced higher Sharpe ratios and stronger returns, relative to total return government bond indices for the G4, US, Germany, Japan, and the UK since 2000. See A "Smarter" (Beta) Way to Trade G4 10y Futures Duration? for more information on these strategies.

Trading Strategy 1 – "Trade Longs/Fade Shorts"

When the 5-day moving average crosses above the 20-day moving average, buy the futures contract (long duration) and hold for a 25 business day period. When the 5-day moving average crosses below the 20-day moving average, buy the futures contract and hold for a 25 business day period. In short, this strategy buys futures when the Simple Moving Average Crossover (SMAX) generates both a long and a short signal, given the historical outperformance of long signals traded long and underperformance of short signals traded short. Given that the SMAX could generate both a long and a short signal within the predefined holding period, an investor may have a 200% long position since each of the two signals would be traded in separate portfolio sleeves.

Trading Strategy 2 – Trade "Longs Only"

When the 5-day moving average crosses above the 20-day moving average, buy the futures contract (long duration) and hold for a 25 business day period. When the 5-day moving average crosses below the 20-day moving average, do nothing. In short, an investor ONLY trades long signals initiated by the SMAX given their historical precedent to outperform

Exhibit 167: Trading signals for G4 smarter (beta) trading strategy

Current Risk, G4 10y Futures	G4 Strategy Weight	Trade Longs Portfolio	Fade Shorts Portfolio	Total Risk Trade Longs Only	Total Risk Trade Longs/Fade Shorts (max 200%)	Trade Longs Portfolio Entry Date	Trade Longs Portfolio Exit Date	Fade Shorts Portfolio Entry Date	Fade Shorts Portfolio Exit Date
JB 10y Future	32.50%	100%	100%	100%	200%	9/9/2020	10/16/2020	7/3/2020	9/16/2020
GE 10y Future	29.25%	100%	100%	100%	200%	9/7/2020	10/12/2020	7/20/2020	9/18/2020
US 10y Future	30.50%	100%	100%	100%	200%	9/4/2020	10/13/2020	8/13/2020	9/18/2020
UK 10y Future	7.75%	100%	100%	100%	200%	9/9/2020	10/14/2020	8/12/2020	9/17/2020

Source: Morgan Stanley Research

Bond Market Indicators

Our BMI(10) models are bearish on the UK and Japan, and neutral on the remaining 5 markets. Vol-adjusted carry is negative in all markets except New Zealand and Australia. Momentum has become a bit more mixed with positive signals in the US, Germany, Australia, and New Zealand, and negative signals in the remaining markets. Equity market signals are modestly positive in all markets except Japan. The FX signal remains strongest in the US.

Our BMI(2) models are neutral on all markets except Japan, where they are bearish and Australia, where they are bullish. Vol-adjusted carry signals are negative in all markets except Australia. Momentum signals are positive in all markets except Japan and Canada. The FX signal remains strongest in the US, as in BMI(10).

Our iBMI models are bullish across the board. Equity signal turned from bullish to bearish for TIPS, less bearish on UKTi and HICPxT and more bullish on JGBi. Momentum signal grew more bullish on UKTi. Oil signal grew more bearish across the board while being bullish on all the regions.

Latest readings

Exhibit 168: Morgan Stanley Bond Market Indicators - BMI(10)

	Vol-Adjusted Carry	Momentum	Equity Markets	Business Cycle	FX	Average	Overall
US	-6.3 (-6.5)	5.0 (-2.8)	0.8 (0.9)	-7.1 (-8.5)	9.5 (9.8)	0.4 (-1.4)	**0.0 (0.0)**
DE	-9.6 (-9.7)	2.2 (-1.7)	0.4 (6.0)	7.9 (-9.3)	-6.7 (-9.0)	-1.2 (-4.7)	**0.0 (-4.7)**
UK	-3.4 (-4.1)	-5.9 (-3.9)	2.7 (6.7)	-7.6 (-9.6)	5.6 (3.7)	-1.7 (-1.4)	**-1.7 (0.0)**
JP	-7.8 (-7.9)	-9.2 (-8.9)	-1.4 (4.6)	5.2 (-9.0)	-3.6 (-1.4)	-3.4 (-4.5)	**-3.4 (-4.5)**
AU	2.0 (0.3)	0.4 (4.0)	5.2 (4.3)	0.2 (-3.0)	-1.6 (-6.5)	1.2 (-0.2)	**0.0 (0.0)**
NZ	0.2 (-0.9)	5.0 (4.7)	2.0 (4.8)	-0.2 (-3.3)	-5.2 (-2.5)	0.4 (0.6)	**0.0 (0.0)**
CA	-8.2 (-8.4)	-3.5 (-5.5)	3.7 (1.5)	5.7 (5.1)	8.4 (8.1)	1.2 (0.2)	**0.0 (0.0)**

Source: Morgan Stanley Research
Note: Positive # = long duration; Negative # = short duration, (#) = previous week Thursday close which may differ from the post-nonfarm payroll update, Indicators bounded between -10 and +10, Overall signal set to zero if abs(Signal)<=1.5

Exhibit 169: Morgan Stanley Bond Market Indicators - BMI(2)

	Vol-Adjusted Carry	Momentum	Equity Markets	Business Cycle	FX	Average	Overall
US	-8.2 (-8.1)	7.6 (4.2)	0.8 (0.9)	-7.1 (-8.5)	9.6 (9.9)	0.5 (-0.3)	**0.0 (0.0)**
DE	-8.3 (-9.1)	0.7 (-4.5)	0.4 (6.0)	7.9 (-9.3)	-6.5 (-6.4)	-1.2 (-4.7)	**0.0 (-4.7)**
UK	-0.6 (1.8)	3.3 (-6.3)	2.7 (6.7)	-7.6 (-9.6)	3.6 (3.4)	0.3 (-0.8)	**0.0 (0.0)**
JP	-6.8 (-7.8)	-9.9 (-9.1)	-1.4 (4.6)	5.2 (-9.0)	-6.0 (-3.5)	-3.8 (-5.0)	**-3.8 (-5.0)**
AU	7.3 (6.9)	6.3 (1.9)	5.2 (4.3)	0.2 (-3.0)	-1.1 (-5.5)	3.6 (0.9)	**3.6 (0.0)**
NZ	-8.1 (-7.3)	7.8 (5.8)	2.0 (4.8)	-0.2 (-3.3)	0.2 (4.7)	0.3 (0.9)	**0.0 (0.0)**
CA	-3.9 (-3.5)	-4.1 (-2.3)	3.7 (1.5)	5.7 (5.1)	0.0 (0.0)	0.4 (0.2)	**0.0 (0.0)**

Source: Morgan Stanley Research
Note: Positive # = long duration; Negative # = short duration, (#) = previous week Thursday close which may differ from the post-nonfarm payroll update, Indicators bounded between -10 and +10, Overall signal set to zero if abs(Signal)<=1.5

Exhibit 170: Morgan Stanley Bond Market Indicators - xBMIs

	Long US	Long DE	Long UK	Long JP	Long AU	Long NZ	Long CA
vs. US	0.0 (0.0)	0.0 (-1.7)	0.0 (0.0)	-1.9 (-1.6)	0.0 (0.0)	0.0 (0.0)	0.0 (0.0)
vs. DE	0.0 (1.7)	0.0 (0.0)	0.0 (1.7)	0.0 (0.0)	0.0 (2.3)	0.0 (2.6)	0.0 (2.4)
vs. UK	0.0 (0.0)	0.0 (-1.7)	0.0 (0.0)	0.0 (-1.5)	0.0 (0.0)	0.0 (0.0)	0.0 (0.0)
vs. JP	1.9 (1.6)	0.0 (0.0)	0.0 (1.5)	0.0 (0.0)	2.3 (2.2)	1.9 (2.5)	2.3 (2.3)
vs. AU	0.0 (0.0)	0.0 (-2.3)	0.0 (0.0)	-2.3 (-2.2)	0.0 (0.0)	0.0 (0.0)	0.0 (0.0)
vs. NZ	0.0 (0.0)	0.0 (-2.6)	0.0 (0.0)	-1.9 (-2.5)	0.0 (0.0)	0.0 (0.0)	0.0 (0.0)
vs. CA	0.0 (0.0)	0.0 (-2.4)	0.0 (0.0)	-2.3 (-2.3)	0.0 (0.0)	0.0 (0.0)	0.0 (0.0)

Source: Morgan Stanley Research
Note: Positive # = long cross market spreads; Negative # = short cross market spread, (#) = previous week Thursday close which may differ from the post-nonfarm payroll update, Indicators bounded between -15 and +15, Signal is set to zero if abs(Signal)<=2

Exhibit 171: Morgan Stanley Euro Sovereign Bond Market Indicators - eBMI

	Business Cycle Surprises	Momentum	Vol. Adj. Carry	Supply	Risky Assets	Overall
Periphery vs. Core	6.9 (9.8)	0.4 (1.4)	9.1 (4.1)	4.4 (-8.0)	-2.4 (-4.6)	**3.7 (0.5)**
Semi-Core vs. Core	10.0 (9.9)	0.4 (1.9)	9.3 (-0.1)	-6.7 (5.8)	-7.5 (-9.7)	**1.1 (1.5)**
Periphery vs. Semi-Core	-1.5 (0)	0.0 (-0.2)	-0.1 (2.1)	5.5 (-6.9)	2.6 (2.5)	**2.6 (-1.0)**

Source: Morgan Stanley Research
Note: Positive # = long spreads; Negative # = short spreads, (#) = previous week Thursday close which may differ from the post-nonfarm payroll update, Indicators bounded between -10 and +10.

Exhibit 172: Morgan Stanley Inflation Bond Market Indicators - iBMI

Market	Oil	Momentum	Equities	Value	Average	Overall
TIPS	-2.4 (-0.4)	6.5 (7.2)	-0.6 (0.7)	1.9 (2.0)	1.3 (2.4)	**1.3 (2.4)**
UKTi	-2.0 (-1.4)	7.9 (6.3)	-0.8 (-2.5)	0.8 (3.3)	1.5 (1.4)	**1.5 (1.4)**
HICPxT	-2.4 (-0.9)	3.5 (6.1)	-0.1 (-1.4)	4.5 (4.5)	1.4 (2.1)	**1.4 (2.1)**
JGBi	-2.0 (-0.5)	3.7 (3.5)	0.7 (0.2)	2.7 (1.9)	1.2 (1.3)	**1.2 (1.3)**

Source: Morgan Stanley Research
Note: Positive # = long inflation breakeven; Negative # = short inflation breakeven, (#) = previous week Thursday close which may differ from the post-nonfarm payroll update, Indicators bounded between -10 and +10, Overall signal set to zero if abs(Signal)<=1.0

How to read the xBMIs

The "FX/Rates" row displays the FX/rates relationship signal. The "Combined BMI differential" row displays the difference between the relevant BMI(10) signals after having applied the signal strength check, i.e., abs(signal) >= 1.5. The "Average xBMI" row displays the average of the "FX/Rates" and "Combined BMI differential" rows. And the "Overall" score requires that the sign of the "Average xBMI" signal match the sign of the "Combined BMI differential" signal and be ≥ the absolute value of 2.

Government Bond Supply

In the US, new 3y was issued, 10y, 30y were re-opened, all for a total of $108bn. These will settle in the next week when $2bn coupons and $24bn redemptions will be paid. **In the euro area,** we expect €20bn issuance (from GER, FRA and SPA) against €2bn coupons and €6bn redemptions (from Finland). **In the UK,** UKTs will be issued for a total of £7bn against no coupons or redemptions. **In Japan,** there will be two auctions for enhanced liquidity for ¥500bn and ¥400bn, respectively, against no coupons or redemptions. **In Canada,** 30y CAN 2% Dec-2051 will be issued for $3bn against $0.03bn coupons and no redemptions. **In Australia,** ACGB 1.5% Jun-31 and ACGB 0.25% Nov-24 will be issued for $2bn each, against no cash flow. **In New Zealand,** NZGB 5.50% Apr-23, NZGB 3.00% Apr-29 and NZGB 3.5% Apr-33 will be issued for $450mn, $350mn and $150mn respectively, against no cash flow.

Exhibit 173: Sovereign supply calendar

Monday	Tuesday	Wednesday	Thursday	Friday
14-SEP	**15-SEP**	**16-SEP**	**17-SEP**	**18-SEP**
	GER: DBR 15-Nov-2027, €4bn UK: UKT 1.25% Gilt 2027, £2.75bn UK: UKT 1.75% Gilt 2037, £1.75bn US: 20y UST Re-opening, $22bn JPY: Auction for Enhanced Liquidity, ¥500bn	GER: DBR 1.25% 15-Aug-2048, €1.5bn UK: UKT 0.375% Gilt 2030, £2.5bn AUS: ACGB 1.5% Jun-31 Tap, $2bn	FRA: OAT Auction, €7.5-8.5bn OAT 0% Feb-2023, OAT 0.5% May-2026, OAT 0.75% May 2028 FRA: Linker Auciton, €0.725-1.25bn OATei 0.1% Mar-2036, OATei 0.7% Jul-2030, OATei 0.1% Jul-2047 SPA: SPGB Auction, €4-5bn* SPGB 0% Apr-2023, SPGB 0.8% Jul-2027, SPGB 4.7% Jul-2041, SPGB 1% Oct-2050 US: 10Y TIPS Re-opening, $12bn NZ: NZGB 5.50% Apr-23 Tap, $450mn; NZGB 3.00% Apr-29 Tap, $350mn; NZGB 3.5% Apr-33 Tap, $150mn CAN: CAN 2% Dec-2051, $3bn	JPY: Auction for Enhanced Liquidity, ¥400bn AUS: ACGB 0.25% Nov-24 Tap, $2bn
21-SEP	**22-SEP**	**23-SEP**	**24-SEP**	**25-SEP**
BEL: OLO Auction, €3bn*	GER: BKO 16-Sept-2022, €5bn NETH: New DSL 15-Jan-2052 via DDA, €4-6bn US: New 2y UST, $52bn*	GER: DBR 15-May-2035, €3.5bn US: New 5y UST, $53bn*	ITA: CTZ Auction, €2.5bn* ITA: BTPei Auction, €1.5bn* US: New 7y UST, $50bn* UK: UKT 0.125% Gilt 2026, £3bn* UK: UKTi 0.125% 2028, £1.5bn* JPY: 40y JGB, ¥500bn* NZ: NZGB 0.5% May-24 Tap, $450mn; NZGB 1.50% May-31 Tap, $350mn; NZGB 2.75% Apr-37 Tap, $150mn	
28-SEP	**29-SEP**	**30-SEP**	**1-OCT**	**2-OCT**
	ITA: BTP Auction, €8-9bn* UK: UKT 0.125% Gilt 2028, £3bn* JPY: 2y JGB, ¥3000bn*	GER: OBL 0% Oct-2025, €4bn	FRA: OAT Auction, €8-9bn* SPA: SPGB Auction, €4-5bn* JPY: 10y JGB, ¥2600bn*	

Source: Morgan Stanley Research, Treasuries
* Morgan Stanley estimate. ** Possible Auction

QIS Macro Strategy Signals

Rates Value - Quantitative Investment Strategies Research: Rule-Based Value Investing

Rates Value is a strategy for investing in global 10y government bond futures. The strategy considers a series of market and macroeconomic variables to drive investment decisions, using a LASSO regression to avoid over-fitting.

Exhibit 174: Rates Value positioning, last 12 months

Country	Oct	Nov	Dec	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep
Australia	22%	-22%	-22%	22%	22%	22%	22%	22%	22%	22%	22%	22%
Canada	-14%	14%	-14%	-16%	16%	16%	16%	16%	-19%	-16%	-17%	-17%
France	21%	20%	22%	22%	22%	22%	22%	22%	22%	19%	19%	-19%
Germany	20%	22%	22%	22%	22%	-22%	21%	21%	21%	20%	20%	21%
Italy	12%	-13%	13%	13%	14%	10%	11%	11%	11%	11%	11%	12%
Japan	22%	22%	22%	22%	22%	22%	22%	22%	22%	22%	22%	22%
Korea	20%	20%	20%	-20%	-20%	22%	22%	22%	22%	-22%	-22%	-20%
UK	14%	14%	15%	15%	15%	17%	-17%	-17%	-17%	16%	16%	15%
US	-20%	21%	-21%	-21%	-20%	19%	-19%	-19%	-19%	19%	19%	19%
Net Duration Exposure	97%	98%	57%	59%	93%	139%	100%	100%	65%	91%	90%	55%

Source: Morgan Stanley Research, Bloomberg

Rates Trend - Quantitative Investment Strategies Research: Investing in Central Bank Momentum

The Rates Trend strategy invests in the front four contracts of global Short-Term Interest Rate (STIR) futures by trend-following, using different look-back windows to generate long and short signals. The strategy incorporates GARCH, a parsimonious statistical model, to capture the time-varying and clustering aspects of market volatility.

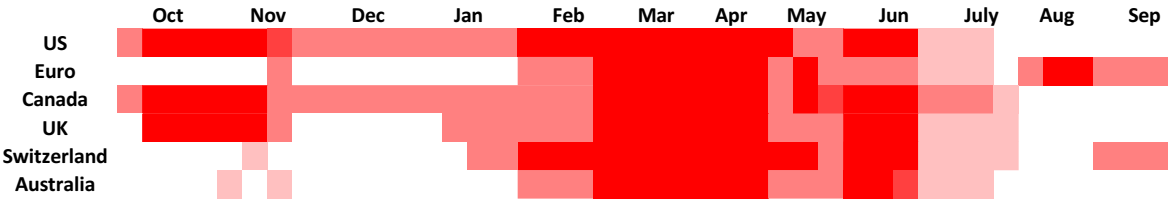
Exhibit 175: Rates Trend net contract exposure, last 12 months

	Oct	Nov	Dec	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep
US	4	4	2	2	4	4	4	4	4	4	4	2
Euro	-2	-4	-4	-4	-2	4	4	4	4	4	2	4
UK	4	-4	-4	-4	4	4	4	4	4	4	2	4
Canada	2	0	0	-2	-4	4	4	4	4	4	2	2
Switzerland	0	-4	-4	-4	-4	4	4	4	3	2	0	2
Australia	2	0	0	2	2	4	4	4	4	4	2	4
Strategy	2	-1	-2	-2	0	4	4	4	4	4	2	4

Source: Morgan Stanley Research, Bloomberg

Note: Numbers represent the net exposure of the strategy among the front 4 contracts for the given country

Exhibit 176: GARCH forecasted volatility regimes, last 12 months



Source: .Morgan Stanley Research, Bloomberg. Red indicates a high volatility regime.

FX Equity-Driven Momentum - Quantitative Investment Strategies: FX Equity-Driven Momentum

FX Equity-Driven Momentum is long/short strategy whose positions in currencies are driven by the relative performance of the corresponding equity markets. The strategy goes long currencies where the local equity market has outperformed the US by Sharpe ratio over the past 3 months, and short currencies which have underperformed the US.

Exhibit 177: FX Equity Momentum Positioning, emerging markets, year to date

Month	BRL	CLP	CNH	COP	CZK	HUF	IDR	ILS	INR	KRW	MXN	PEN	PHP	PLN	RON	RUB	SGD	THB	TRY	TWD	ZAR	USD
Jan	-2%	-3%	-3%	-3%	-5%	-2%	-6%	-6%	-5%	-2%	-3%	-7%	-5%	-4%	-6%	0%	-10%	-7%	-2%	-5%	-2%	88%
Feb	-2%	-3%	-5%	-3%	-5%	-4%	-5%	-6%	-5%	-2%	-3%	-7%	-5%	-4%	-6%	-3%	-10%	-7%	-2%	-9%	-2%	100%
Mar	-2%	-3%	6%	-3%	-4%	-4%	-4%	-5%	-6%	-2%	-1%	-7%	-7%	-4%	-5%	-2%	-11%	-6%	-1%	-6%	-3%	80%
Apr	-2%	-3%	-7%	-3%	-3%	-4%	-4%	-3%	-6%	-3%	-2%	-5%	-8%	-5%	-6%	-1%	-9%	-6%	-3%	-12%	-3%	98%
May	-2%	-4%	8%	-3%	-3%	-4%	-4%	-3%	-6%	-4%	-2%	-5%	-8%	-5%	-6%	-2%	-9%	-6%	-3%	-5%	-2%	77%
Jun	-2%	-2%	-3%	-2%	-2%	-2%	0%	2%	-6%	0%	-2%	-5%	-6%	-1%	-2%	0%	-7%	1%	-3%	-4%	-2%	49%
Jul	-1%	-1%	5%	-2%	-1%	-3%	2%	4%	-1%	5%	-2%	-5%	-6%	-1%	-1%	-1%	-8%	5%	-2%	10%	-1%	5%
Aug	2%	-3%	-1%	-3%	-1%	-3%	-3%	-1%	8%	5%	-2%	-5%	-9%	3%	-4%	-2%	-9%	-6%	-3%	11%	-2%	28%
Sep	-1%	-3%	7%	-3%	-3%	-3%	-3%	-5%	7%	2%	-2%	-5%	-9%	-3%	-4%	-3%	-8%	-6%	-2%	12%	-2%	37%

Source: Morgan Stanley Research, Bloomberg. Percentages represent the average exposure of the strategy in each currency forward for the given month.

Exhibit 178: FX Equity Momentum Positioning, developed markets, year to date

Month	AUD	CAD	CHF	EUR	GBP	JPY	NOK	NZD	SEK	USD
Jan	-10%	-8%	-12%	-13%	-6%	-13%	-9%	-3%	-9%	83%
Feb	-10%	-14%	15%	-14%	-6%	-13%	-9%	5%	-9%	55%
Mar	-8%	-17%	-2%	-16%	-8%	-9%	-9%	-2%	-8%	78%
Apr	-8%	-17%	-9%	-17%	-8%	-9%	-6%	-9%	-12%	95%
May	-8%	-13%	-15%	-17%	-9%	-10%	-7%	-4%	-13%	96%
Jun	-5%	-5%	-5%	-3%	-9%	10%	0%	-1%	-3%	22%
Jul	2%	-4%	-5%	-6%	-10%	1%	-3%	7%	-5%	23%
Aug	-2%	3%	-14%	5%	-10%	-14%	-6%	-2%	10%	31%
Sep	-9%	-3%	-14%	-11%	-11%	-14%	-7%	-9%	-2%	79%

Source: Morgan Stanley Research, Bloomberg. Percentages represent the average exposure of the strategy in each currency forward for the given month.

FX Value - Quantitative Investment Strategies Research: Rule-Based Value Investing

FX Value is a strategy for investing in Developed Market currency forwards. The strategy combines two models: (1) A two-factor mean variance model and (2) a long-run mean-reversion model to determine investment decisions around G10 currencies.

Exhibit 179: FX Value Positioning, last 12 months

Date	Oct	Nov	Dec	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep
AUD	-2%	1%	-14%	6%	-13%	6%	6%	-1%	1%	2%	2%	2%
CAD	-13%	-13%	-14%	-13%	-13%	-13%	-13%	-13%	-13%	-13%	-13%	-15%
EUR	-13%	-13%	-14%	-13%	-13%	-13%	-13%	-13%	-13%	-13%	-13%	-15%
JPY	-13%	-13%	-14%	-13%	-13%	-13%	-13%	-13%	-13%	-13%	-13%	-15%
NZD	23%	25%	37%	31%	13%	29%	29%	23%	25%	26%	26%	29%
NOK	-2%	-13%	-14%	-13%	-13%	-13%	-13%	-4%	-7%	-8%	-8%	-15%
SEK	-2%	2%	18%	6%	43%	9%	9%	2%	4%	5%	-5%	4%
CHF	-13%	-13%	-14%	-13%	-13%	-13%	-13%	-13%	-13%	-13%	-13%	-15%
GBP	0%	2%	-14%	-13%	-13%	-13%	-13%	-1%	-5%	-6%	-6%	-15%
USD	35%	36%	42%	38%	35%	32%	35%	33%	34%	34%	44%	55%

Source: Morgan Stanley Research, Bloomberg. Percentages represent the exposure of the combined FX Value strategy in each currency forward.

In Case You Missed It

US Economics: The Fed's New Framework: This Time Is Different
11 Sept 2020
With its new framework, the Fed is more likely to achieve its inflation target in this cycle, supporting our out-of-consensus call for higher inflation. We expect conditions will be in place for the Fed to raise rates by 1H 2024, if not sooner, with balance sheet tapering to start around mid-2022.

United Kingdom: Brexit: It's Back
11 Sept 2020
The UK has signalled willingness to walk away from Brexit talks. Although we still expect a pragmatic deal, maybe as late as November, we now see a 40% risk of a WTO outcome.

US Election: The Waiting Is the Hardest Part
8 Sept 2020
Prepare to wait beyond Election Day for a final result. Increased use of vote by mail could delay counting, and markets could struggle to price in a policy path. Although Election Day vol is priced in, we see value in macro hedges covering the following days and weeks.

Global Macro Strategy: ECB Purchase Programmes Update
7 Sept 2020
We highlight the key statistics and monthly activity across the ECB asset purchase programmes, focusing on the PSPP and PEPP.

ECB Preview: A Steady Hand
3 Sept 2020
With only a modest change in the forecast and uncertainty still high, we see the ECB continuing to buy and a dovish message. Weak inflation calls for further action, but with ample resources left in PEPP, we don't expect another top-up yet.

Japan Strategy & Economics: Abe-san's legacy likely to be lasting
28 Aug 2020
The key reforms of the Abenomics-era are likely to be sustained by whoever emerges as his successor. We are buyers on weakness of Topix below our June 2021 target of 1550 (-4% versus spot) and also expect near term JPY strength to reverse targeting 112.

US Economics and Global Macro Strategy: Jackson Hole: A Historic Moment, But Not For All
27 Aug 2020
The Fed has now formalized a more dovish path over this cycle, but raising credibility around achieving its inflation goal will take time to fully bear out. Our strategists still suggest long 5y TIPS outright and versus 30y UST, and on USD, they remain tactically neutral but structurally bearish.

Forecasts

Government bonds

Exhibit 180: Morgan Stanley sovereign 2y, 5y, 10y, and 30y yield base case forecasts

	2Y						5Y						10Y						30Y					
	3Q20	4Q20	1Q21	2Q21	3Q21	4Q21	3Q20	4Q20	1Q21	2Q21	3Q21	4Q21	3Q20	4Q20	1Q21	2Q21	3Q21	4Q21	3Q20	4Q20	1Q21	2Q21	3Q21	4Q21
US	0.15	0.15	0.15	0.15	0.15	0.20	0.30	0.45	0.45	0.50	0.50	0.60	0.75	0.95	0.95	1.00	1.05	1.20	1.50	1.75	1.75	1.85	1.90	2.05
Germany	-0.60	-0.55	-0.55	-0.55	-0.55	-0.50	-0.55	-0.45	-0.40	-0.35	-0.30	-0.25	-0.30	-0.10	-0.05	0.05	0.10	0.15	0.15	0.30	0.35	0.45	0.55	0.65
Japan	-0.15	-0.15	-0.15	-0.15	-0.15	-0.15	-0.10	-0.10	-0.10	-0.10	-0.10	-0.10	0.00	0.00	-0.05	0.00	0.00	0.00	0.55	0.50	0.40	0.50	0.50	0.50
UK	0.00	0.00	0.05	0.10	0.10	0.15	0.05	0.10	0.15	0.25	0.25	0.30	0.20	0.25	0.35	0.45	0.50	0.60	0.65	0.75	0.85	0.95	1.00	1.15
Canada	0.20	0.20	0.20	0.20	0.25	0.30	0.45	0.50	0.55	0.60	0.65	0.70	0.70	0.80	0.85	0.85	0.90	1.00	1.30	1.45	1.50	1.55	1.60	1.65
Australia	0.25	0.25	0.25	0.25	0.25	0.25	0.40	0.45	0.50	0.50	0.50	0.55	1.00	1.05	1.10	1.10	1.15	1.20	1.85	1.95	2.10	2.10	2.15	2.20
New Zealand	0.25	0.25	0.25	0.25	0.25	0.25	0.40	0.45	0.50	0.55	0.60	0.60	0.95	1.00	1.05	1.10	1.15	1.20						
Austria*	5	5	0	0	0	0	15	10	5	5	5	5	20	15	10	5	5	5	20	15	10	5	5	5
Netherlands*	5	0	0	0	0	0	5	0	0	0	0	0	15	10	5	0	0	0	0	0	-5	-5	-5	-5
France*	5	5	5	5	5	5	15	10	5	5	5	5	25	20	15	15	15	15	55	50	45	40	35	35
Belgium*	5	5	5	5	5	5	15	10	5	5	5	5	30	25	20	20	20	20	55	50	45	40	35	35
Ireland*	10	5	5	5	5	5	25	15	5	5	5	5	35	30	25	20	15	15	60	55	50	45	40	35
Spain*	20	15	10	10	10	10	40	30	20	15	15	15	65	55	45	35	30	30	105	90	75	60	55	50
Italy*	60	40	35	30	30	30	110	80	60	50	45	40	145	115	100	90	80	70	205	175	150	135	120	110
Portugal*	15	15	10	10	10	10	45	35	25	20	15	15	60	45	35	30	25	20	105	90	75	60	55	50

Source: Morgan Stanley Research, *Spread to German Bunds

Exhibit 181: Morgan Stanley sovereign 10-year yield bull, base, and bear case forecasts

	Bull						Base						Bear					
	3Q20	4Q20	1Q21	2Q21	3Q21	4Q21	3Q20	4Q20	1Q21	2Q21	3Q21	4Q21	3Q20	4Q20	1Q21	2Q21	3Q21	4Q21
US	0.75	0.55	0.45	0.40	0.40	0.40	0.75	0.95	0.95	1.00	1.05	1.20	1.35	1.50	1.55	1.65	1.65	1.80
Germany	-0.60	-0.70	-0.75	-0.75	-0.85	-0.85	-0.30	-0.10	-0.05	0.05	0.10	0.15	0.00	0.15	0.25	0.35	0.50	0.60
Japan	-0.05	-0.05	-0.10	-0.05	-0.05	-0.05	0.00	0.00	-0.05	0.00	0.00	0.00	0.05	0.05	0.00	0.05	0.10	0.15
UK	0.05	0.00	-0.05	-0.10	-0.10	-0.15	0.20	0.25	0.35	0.45	0.50	0.60	0.40	0.50	0.60	0.75	0.90	1.00
Canada	0.40	0.35	0.35	0.35	0.35	0.35	0.70	0.80	0.85	0.85	0.90	1.00	0.75	0.90	0.95	1.05	1.15	1.20
Australia	0.70	0.60	1.45	0.50	0.40	0.40	1.00	1.05	1.10	1.10	1.15	1.20	1.10	1.30	0.45	1.30	1.60	1.65
New Zealand	0.60	0.50	0.45	0.40	0.40	0.40	0.95	1.00	1.05	1.10	1.15	1.20	1.10	1.20	1.25	1.30	1.35	1.40
Austria*	10	5	0	0	0	0	20	15	10	5	5	5	45	55	60	65	70	75
Netherlands*	5	0	-5	-5	-5	-5	15	10	5	0	0	0	35	40	45	50	55	60
France*	15	10	5	0	0	0	25	20	15	15	15	15	60	75	85	90	95	100
Belgium*	20	15	10	5	5	5	30	25	20	20	20	20	75	85	95	100	105	110
Ireland*	20	15	10	5	0	0	35	30	25	20	15	15	80	90	100	105	110	115
Spain*	45	35	30	25	20	20	65	55	45	35	30	30	140	175	185	195	205	215
Italy*	100	75	65	55	50	50	145	115	100	90	80	70	250	300	315	330	340	350
Portugal*	35	25	20	15	10	10	60	45	35	30	25	20	150	180	190	200	210	220

Source: Morgan Stanley Research, *Spread to German Bunds

Exhibit 182: Morgan Stanley foreign exchange base case forecasts

	3Q20	4Q20	1Q21	2Q21	3Q21	4Q21
EUR/USD	1.15	1.16	1.18	1.20	1.21	1.23
USD/JPY	109	110	110	112	112	112
GBP/USD	1.25	1.25	1.22	1.25	1.28	1.30
USD/CHF	0.95	0.95	0.94	0.93	0.96	0.98
USD/SEK	9.30	9.14	8.90	8.67	8.43	8.13
USD/NOK	8.96	8.75	8.90	9.17	9.09	8.94
USD/CAD	1.31	1.30	1.31	1.33	1.35	1.35
AUD/USD	0.71	0.73	0.74	0.74	0.74	0.74
NZD/USD	0.64	0.65	0.67	0.68	0.69	0.70
EUR/JPY	125	128	130	134	136	138
EUR/GBP	0.92	0.93	0.97	0.96	0.95	0.95
EUR/CHF	1.09	1.10	1.11	1.12	1.16	1.20
EUR/SEK	10.70	10.60	10.50	10.40	10.20	10.00
EUR/NOK	10.30	10.15	10.50	11.00	11.00	11.00
USD/CNY	6.83	6.80	6.75	6.70	6.65	6.60
USD/HKD	7.85	7.80	7.75	7.75	7.75	7.75
USD/IDR	13850	13800	13700	13600	13500	13500
USD/INR	75.2	74.8	74.4	74.0	73.8	73.6
USD/KRW	1215	1210	1205	1200	1190	1180
USD/MYR	4.26	4.25	4.24	4.21	4.19	4.17
USD/PHP	49.7	49.5	49.4	49.2	49.0	49.0
USD/SGD	1.39	1.38	1.38	1.38	1.37	1.37
USD/TWD	29.7	29.6	29.5	29.4	29.4	29.3
USD/THB	31.4	31.2	31.0	30.6	30.4	30.0
USD/BRL	5.10	5.05	5.00	5.00	5.00	5.00
USD/MXN	21.90	21.65	21.90	22.05	22.20	22.40
USD/ARS	75.00	82.50	87.75	94.00	101.00	108.00
USD/CLP	775	795	800	800	800	800
USD/COP	3560	3650	3650	3650	3650	3650
USD/PEN	3.40	3.45	3.40	3.40	3.40	3.40
USD/ZAR	16.0	16.0	16.5	16.5	16.5	16.5
USD/TRY	6.50	6.50	6.70	6.80	7.00	7.00
USD/ILS	3.48	3.46	3.46	3.46	3.46	3.46
USD/RUB	66.0	65.0	65.0	64.5	64.0	63.5
EUR/PLN	4.38	4.36	4.33	4.30	4.28	4.25
EUR/CZK	26.4	26.2	25.8	25.4	25.1	24.8
EUR/HUF	344	342	341	340	340	339
DXY Index	96	95	95	94	93	92
Fed's Broad USD Index	119	118	118	118	118	118

Source: Morgan Stanley Research. Click here for custom cross forecasts

Exhibit 183: Morgan Stanley foreign exchange Base, Bear, Bull scenarios

2Q21	Bear	Base	Bull
EUR/USD	1.14	1.20	1.26
GBP/USD	1.15	1.25	1.35
USD/JPY	105	112	115
AUD/USD	0.68	0.74	0.76
USD/INR	71.8	74.0	77.7
USD/ZAR	15.7	16.5	18.2
USD/BRL	4.85	5.00	5.35
USD/MXN	21.40	22.05	24.00

Source: Morgan Stanley Research

Trade Ideas

Below you will find a list of our current trade ideas, entry levels, entry dates, rationales, and risks.

Interest Rate Strategy				
TRADE	**ENTRY LEVEL**	**ENTRY DATE**	**RATIONALE**	**RISKS**
Long 10y USD denominated JGB ASW	3mL+62bp	11-Sep-20	Still attractive yield pick-up vs historical standard	Worsening of tighter credit conditions leads to the widening of long-end USD/JPY basis
Short UKT 30y vs long DBR 30y	77bp	14-Aug-20	We anticipate a notable supply mismatch between long-end UKTs and long-end DBRs in the coming months. Past seasonality has also shown a strong bias for longer-maturity UKTs to underperform DBRs during the months of September and October. UK data has been slow to recover versus that of Europe, but positive surprises could include long-end syndications.	The MPC's new forecasts for employment may prove too optimistic depending on the evolution of the furlough schemes, while Brexit talks remain another downside risk. New issuance from the EU could weigh on Bunds, potentially leading Bunds to underperform gilts despite less supply in Germany.
New Zealand 10Y Swap spread tightener	42bp	10-Jul-20	The widening in swap spreads with cash bonds rising relative to OIS is, in our view, a temporary phenomenon driven by higher-than-expected net supply estimates. We think the RBNZ will react to alleviate these issues, putting downward pressure on cash bonds and narrowing swap spreads.	The risk is that the RBNZ fails to act sufficiently dovish, which keeps cash bonds elevated relative to swaps, or that the Crown increases its issuance estimates further.
Long20s on10s20s30s butterfly	12bp	10-Jul-20	We see 20y point being attractive given its higher rolldown and carry, and limited loss in convexity, vs. a barbell of 10s and 30s.	The risk is that 20y point starts to cheapen vs 10s and 30s based on supply concerns or lack of demand.

Underweight 10y UST and 10y DBR vs 10y UKT and 10y ACGB	-22.6bp	10-Jun-20	In the US, a fast economic recovery along with an even higher expectation for supply could drive the curve steeper, while in Germany the skew for Bunds appears to be higher in the light of the creation of a substitute AAA rated EU debt for financing SURE and Next Generation EU in 2020 and 2021, respectively. In relative terms, in the UK the curve should flatten more on the expectation of NIRP and easy MPC policy, while in Australia the relative demand driven by RBA and foreign investors should help the curve to steepen less than the US and German ones.	Reemergence of Covid or less pronounced economic recovery would lead investors to bid for safe haven assets, which in turn would support US Treasuries and Bunds more than UK Gilts and Australian bonds. This would flatten the US and German curves more than those in the UK and Australia.
Long 10y BTP vs 10y Bund	188bp	10-Jun-20	We expect the EU recovery fund and ECB buying to create negative net technical for supply that should support Italian yield compression. At the same time, skew for Bunds is negative since the issuance of common European Debt would create an alternative to Bunds, which would edge higher, tightening the spread.	Reemergence of Covid, larger than expected increase in Italian issuance needs, and /or failure of EU to agree on a recovery plan would trigger a sell-off in Italian debt, leading to a widening in spread to Bunds.
Long 20y JGB vs pay 2y swap	44 bp	11-Sep-20	As government fiscal spending moves through the real economy, money will eventually go to banks' deposits. We believe banks will prefer 20y JGBs from both carry and capital gains perspectives. Banks may have less demand for the belly now that they can earn both 0% and 0.1% headroom via new BoJ lending facilities.	Less demand from banks in 20y sector.
Buy September 2040 NZ inflation-indexed bond	30bp	15-May-20	We think the RBNZ will remain dovish and, through its newly announced expanded asset purchases, will seek to flatten the nominal and real yield curves. We buy the September 2040 inflation-indexed bond outright, which we believe will rally the most under the RBNZ's easing measures.	The RBNZ front-loads its purchases and purchases relatively few IIBs, leading to a bear steepening of the yield curve.
10y Netherlands vs 10y Germany	28bp	24-Apr-20	We look for the ECB to, at some point, conduct make-up purchases in the Netherlands given material deviation from the capital key. We see the 10y spread as relatively dislocated vs relationships relative to Bunds. We believe markets will start to build concessions for Germany coupon supply in coming weeks while the EUR142bn could be sold out to the market if Germany needs additional funding.	The Netherlands decides to issue significantly more debt than currently indicated in response to COVID-19, while the periphery continues to keep widening due in part to downgrade concerns in various countries.
NZGB 2s10s Flatteners	76bp	24-Apr-20	We expect the RBNZ to ease further in May by increasing the size of its government bond purchases. So far, purchases have been biased toward the front end, but if purchases are increased, the RBNZ may need to purchase more long-end bonds given capacity constraints.	The risk is that net issuance by the government increases in the front end, giving the RBNZ more bonds to buy in that part of the curve and thus limiting the need to buy more long-end bonds.

CAGB Cash-OIS Widener	21bp	24-Jul-20	We suggest investors position for a reversal in the falling cash-OIS spread as nominal yields rise relative to CAD OIS policy expectations. Nominal yields in Canada are likely to face upward pressure, particularly at the long end due to sizeable issuance in the pipeline and rising global growth expectations. OIS policy expectations are likely to fall as investors reprice BoC expectations in reaction to Fed policy.	Inflation rises sharply in Canada and/or that the BoC signals its intention to raise rates more quickly than expected
JPYswap 20s30s flattener	11.5bp	4-Oct-19	Long-end JPY swap curve appears to be too steep vs those in the regions that have adopted a negative interest rate policy.	Global risk recovery and the subsequent paying demand
Buy 5y JGB EUR/GBP ASW	25bp (vs 3m EURIBOR)	25-Jan-19	Attractive carry rolldown and tightening view for the belly of Xccy basis	Worsening of credit conditions and resuming heavy supply of Samurai issuance

Currency and Foreign Exchange

TRADE	ENTRY LEVEL	ENTRY DATE	RATIONALE	RISKS
Buy 3m EUR/NOK ATMF call spread (buy 50D call, sell 25D call)	1.03%	7-Sep-20	As a tail hedge against market volatility after the US election, we propose buying a EUR/NOK call spread. NOK is the most correlated G10 currency to US equities this year, and vol is relatively cheap versus history.	This is a tail-risk hedge should the mail-in ballots for the election take a while to count. If equity markets continue to rise, this trade will not work and EUR/NOK is more likely to fall.
Sell 6m EUR/CHF ATMF (1.0760) puts	1.39%	16-Jul-20	We suggest adding long EUR/CHF exposure as a lower-volatility way of expressing the bullish eurozone/Europe theme. EUR/CHF downside is limited by the Swiss National Bank intervention, which we think will get more aggressive the more EUR/CHF falls down towards 1.05. The trade benefits from the still negative skew as investors have bought CHF as a broader risk hedge.	Peripheral spread widening and a broader risk-off period, which may occur in August, although we are confident the SNB will reduce the upside for CHF
Long AUD/NZD	1.0571	10-Jul-20	AUD/NZD should gain as the RBNZ pushes downward pressure on local bond yields and as foreign investors continue to sell their NZGB holdings to the RBNZ and repatriate capital.	The RBNZ turns more hawkish, narrowing policy differentials, and/or risk sentiment softens.

Inflation-Linked Bonds

TRADE	ENTRY LEVEL	ENTRY DATE	RATIONALE	RISKS
Long 5y real yields	-97bp	10-Jul-20	We see a significant potential for real yields to move lower over the coming months based on a dovish Fed, inflation based forward guidance, and an improving economy.	The key risk is a risk-off period in which TIPS real yields rise.
Long 30-year breakevens	139bp	1-May-20	We suggest being long 30y breakevens as a trade that offers value, can do well in risk-on conditions, and could benefit from the investors' focus on long-term inflation prospects driven by the unprecedented fiscal monetary coordination.	Continued deterioration in financial conditions.

Short-Duration Strategy

TRADE	ENTRY LEVEL	ENTRY DATE	RATIONALE	RISKS
Pay USDJPY basis 5y5y	-68bp	19-Jun-20	Further tightening of global credit spreads and demand for carry.	Deal-related receiving flow in the longer end. Worsening credit conditions.

Interest Rate Derivatives

TRADE	ENTRY LEVEL	ENTRY DATE	RATIONALE	RISKS

Long USD 3m10y ATMF straddle, delta hedged	60.2bp	4-Aug-20	Rates volatility stands out for being unusually low versus history, standing in the th percentile when equity/credit and commodity vols are in the top quintile. We are close to a floor on volatility, especially in the context of already low yields and a heavy event calendar over the next three months. Our analysis suggests that, following a period with very stretched implied risk premium, realised volatility tended to pick up in the month after.	Rates continue to trade within a tight range and low realised volatility drives implied vols lower.
Long USD 100mm 6m30y ATM vs. ATM+52bp payer spread vs. short 400mm 6m7y ATM payer spread	0c	26-Jun-20	The trade expresses our macro view on a steeper 7s30s curve in rates vol space. It carries positively to expiry and benefits from a steeper 7s30s curve. The trade is flat p&l under a bull flatter curve.	The two main risks to the trades are if the rate curve bear flattens or if the 7y rate moves by more than 50bp higher and the 7s30s spread widens by more than 80b at the same time.
Long USD 6m30y 1x2 vanilla receiver spread A-25 vs. A-49bp (0.95% vs 0.71%)	0c	5-Jun-20	30y vol and skew have richened, providing an attractive opportunity for a 1x2 receiver distribution trade to hedge for a bull flattening move. The terminal distribution captures all historical low levels of 30y swap rate in the US.	The main risk to the trade is a sharp global rally in rates similar to that in summer 2016 or 2019, which takes the 30y swap rate in the US closer to the zero lower bound.
Long USD 1x notional 2y30y 1.35% vanilla payer vs short 1x notional 1y1y30y 1.35% midcurve payer	196c	15-May-20	The trade takes advantage of the inverted expiry term structure on 30s and struck high on the payer side to position for a move higher on the long end of the curve over the next 6m to 1y horizon. Over the course of the next 6m to 1y investment horizon, the trade earns positive carry with a wide breakeven range relative to underlying rate shifts.	The main risk to the trade is if the 30y rate goes lower by more than 60bp or higher by more than 120bp.
Long US 2y3y30y FVA	2110c	24-Apr-20	Intermediate to bottom right implied forward volatility is trading at historical lows. The trade benefits from positive roll and carry, an overall bid tone in vol, or a flattening in the vanilla vol surface.	The main risk to the trade is if the vanilla vol surface on 30y tail softens without a flattening in the expiry curve. In such case, the implied forward vol could continue to drift to historically low levels in the low 50s area.
Short US 1x3 0% strike floor vs long US 1y2y 0% strike vanilla receiver swaption	Bid price at 17c vs offer price at 8.5c	24-Apr-20	The bid in cap/floor vol on the back of hedging flows has led to a divergence vs. the vanilla swaption vol. Points within the first 5 years of history, such as 1x2, 1x3, 2x3, 3x4, 3x5, are among the most stretched ones.	The main risk is if 0% floor vol continues to be bid, resulting in a further divergence vs. swaption receiver skew.

Exhibit 184: History of recommendations

History of recommendations for short UKT 30y vs. long DBR 30y										
Instrument	Maturity	Trade	Entry Date	Entry Level	Exit Date	Exit Level	Target/ Objective	Stop/Re-assess	Size of Trade or Unit/Notional	CUSIP / ISIN / BLOOMBERG
OBL 0.000 10/18/2024	18-Oct-24	Bund/Germany 5s30s Steepener	06-Sep-19	-0.88%	28-Feb-20	-0.78%				DE0001141802
DBR 0.000 08/15/2050	15-Aug-50	Bund/Germany 5s30s Steepener	06-Sep-19	-0.08%	28-Feb-20	-0.14%				DE0001102481
OBL 0.000 10/18/2024	18-Oct-24	Bund/Germany 5s30s Steepener	06-Sep-19	-0.88%	17-Mar-20	-0.73%	Closed			DE0001141802
DBR 0.000 08/15/2050	15-Aug-50	Bund/Germany 5s30s Steepener	06-Sep-19	-0.08%	17-Mar-20	-0.17%				DE0001102481

Source: Morgan Stanley Research

Definition of terms

Buy/Long: The analyst expects the total or excess return (depending on the nature of the recommendation) of the instrument or issuer that is the subject of the investment recommendation to be positive over the relevant time period.

Sell/Short: The analyst expects the total or excess return (depending on the nature of the recommendation) of the instrument or issuer that is the subject of the investment recommendation to be negative over the relevant time period.

Selling protection or Buying Risk: The analyst expects that the price of protection against the event occurring will decrease over the relevant time period.

Buying protection or Selling Risk: The analyst expects the price of protection against the event occurring will increase over the relevant time period.

Pay: The analyst expects that over the specified time period the variable rate underlying the swap agreement that is the subject of the investment recommendation will increase.

Receive: The analyst expects that over the specified time period the variable rate underlying the swap agreement that is the subject of the investment recommendation will decrease.

Unless otherwise specified, the time frame for recommendations included in the Morgan Stanley Fixed Income Research reports is 1 - 3 months and the price of financial instruments mentioned in the recommendation is as at the date and time of publication of the recommendation.

When more than one issuer or instrument is included in a recommendation, analyst expects one part of the trade to outperform the other trade or combination of other trades included in the recommendation on a relative basis.

For important disclosures related to the proportion of all investment recommendations over the past 12 months that fit each of the categories defined above, and the proportion of issuers corresponding to each of those categories to which Morgan Stanley has supplied material services, please see the Morgan Stanley disclosure at https://ny.matrix.ms.com/eqr/article/webapp/c7977280-cb9b-11ea-9559-949bcbd11cfb?ch=rpint&sch=ar

Event Calendar

Click here for an interactive, searchable, longer calendar

Exhibit 185: Risk Event Calendar

Date	Time (Ldn)	Ccy	Event	Ref. Period	MS forecast	Market	Previous
12-Sep	N/A	EUR	Informal Ecofin Meeting				
12-18 S	N/A	PHP	Foreign Reserves	Aug			98.6B
13-Sep	23:30	NZD	Performance Services Index	Aug			54.3
14-Sep	N/A	JPY	LDP Party Leadership Election				
	02:10	JPY	BoJ Outright Bond Purchases 10-25y				
	02:30	CNY	New Home Prices (MoM)	Aug			0.47%
	03:00	NZD	RBNZ's Bascard spks (Prudential Supervision)				
	05:30	JPY	Tertiary Industry Index (MoM)	Jul	0.5%	0.5%	7.9%
	05:30	JPY	Industrial Production (MoM)	Jul F			8%
	07:30	EUR	Bank of France Business Sentiment	Aug		100	99.4
	07:30	INR	Wholesale Prices (YoY)	Aug	-0.4%	-0.31%	-0.58%
	N/A	GBP	Internal Market Bill Presented in Parliament				
	09:00	CHF	SNB Sight Deposits				702.9B
	10:00	EUR	Industrial Production (MoM)	Jul	4.6%	4%	9.1%
	13:00	INR	CPI (YoY)	Aug	6.9%	6.9%	6.93%
	13:00	EUR	EU-China Leaders Teleconference				
	14:30	EUR	ECB's Lane spks				
	22:00	KRW	Export Price Index (YoY)	Aug			-5.8%
	22:00	NZD	Westpac Consumer Confidence Index	3Q			97.2
15-Sep	N/A	INR	Trade Balance	Aug	$-7.5B	$-7B	$-4.8B
	N/A	INR	Exports (YoY)	Aug	-6.6%		-10.2%
	00:30	AUD	Consumer Confidence				91.1
	02:30	AUD	RBA Minutes	Sep-01			
	02:30	AUD	House Price Index (QoQ)	2Q		-1.3%	1.6%
	03:00	CNY	Industrial Production (YoY)	Aug	5.2%	5.1%	4.8%
	03:00	CNY	Retail Sales (YoY)	Aug	0.0%	0%	-1.1%
	03:00	CNY	Fixed Assets Ex Rural YTD (YoY)	Aug	-0.5%	-0.5%	-1.6%
	03:00	CNY	Unemployment Rate	Aug		5.6%	5.7%
	06:00	PEN	GDP (YoY)	Jul			-18.06%
	07:00	NOK	Trade Balance	Aug			-1.77B
	07:00	GBP	Jobless Claims Change	Aug			94.4k
	07:00	GBP	Employment Change (3M/3M)	Jul	-18k	-125k	-220k
	07:00	GBP	Average Weekly Earnings (Ex. Bonuses, 3M/Y)	Jul	-0.2%	-0.2%	-0.2%
	07:00	GBP	ILO Unemployment Rate 3Mths	Jul	4.2%	4.1%	3.9%
	07:45	EUR	French CPI (YoY)	Aug F	0.2%	0.2%	0.2%
	08:15	EUR	ECB's Panetta spks				
	08:30	SEK	Unemployment Rate	Aug			8.9%
	09:00	PLN	CPI (YoY)	Aug F	2.9%		2.9%

	09:00	NOK	Regional Network Survey Output 6m out	Aug			0.08%
	09:00	EUR	Italian HICP (YoY)	Aug F	-0.5%	-0.5%	-0.5%
	10:00	EUR	German ZEW Survey Expectations	Sep	69.1	70	71.5
	10:00	EUR	German ZEW Survey Current Situation	Sep		-72	-81.3
	10:00	EUR	Eurozone ZEW Survey Expectations	Sep			64
	N/A	NZD	Global Dairy Trade Announces Milk Auction Results				
	N/A	PLN	NBP Rates Decision		0.10%	0.1%	0.1%
	13:30	CAD	Manufacturing Sales (MoM)	Jul			20.73%
	13:30	USD	Empire Manufacturing	Sep		5.5	3.7
	14:00	CAD	Existing Home Sales (MoM)	Aug			26%
	14:15	USD	Industrial Production (MoM)	Aug	0.1%	1.05%	3%
	14:15	USD	Capacity Utilization	Aug		71.65%	70.6%
	14:15	USD	Manufacturing Production (MoM)	Aug		2.2%	3.4%
	16:30	ILS	CPI (YoY)	Aug		-0.6%	-0.6%
	23:45	NZD	Current Account Balance	2Q		0.69B	1.6B
15-16 S	N/A	NZD	Pre-Election Economic and Fiscal Update				
15-22 S	N/A	GBP	Internal Market Bill Committee Stage Debate				
16-Sep	N/A	JPY	Extraordinary Diet session				
	00:50	JPY	Trade Balance	Aug	-20B	-20B	10.9B
	00:50	JPY	Exports (YoY)	Aug	-15.6%	-16%	-19.2%
	01:30	AUD	Westpac Leading Index (MoM)	Aug			0.05%
	02:10	JPY	BoJ Outright Bond Purchase 1-3y, 3-5y, 5-10y				
	07:00	GBP	CPI (YoY)	Aug	0.0%	0.1%	1%
	07:00	GBP	CPI Core (YoY)	Aug	0.4%	0.6%	1.8%
	08:00	EUR	European Commission President von der Leyen spks (State of the Union Address)				
	09:00	SEK	Central Government Budget and Public Finances Forecasts				
	10:00	EUR	Trade Balance	Jul		19.3B	17.14B
	10:30	EUR	ECB's Hernandez de Cos spks				
	11:00	ILS	GDP (QoQ)	2Q P			-28.7%
	13:30	USD	Retail Sales Advance (MoM)	Aug	4.6%	1%	1.2%
	13:30	USD	Retail Sales Ex Auto (MoM)	Aug	4.6%	1%	1.9%
	13:30	USD	Retail Sales Control Group (MoM)	Aug	3.4%	0.3%	1.4%
	13:30	CAD	CPI (YoY)	Aug			0.1%
	13:30	CAD	Core CPI - Common (YoY)	Aug			1.3%
	15:00	USD	Business Inventories	Jul		0.2%	-1.1%
	15:00	USD	NAHB Housing Market Index	Sep		78	78
	15:30	USD	EIA Crude Oil Inventories				2033k
	16:00	EUR	ECB's Holzmann spks (Economy)				
	19:00	USD	FOMC Rate Decision (Upper Bound)		0.25%	0.25%	0.25%
	19:00	USD	FOMC Rate Decision (Lower Bound)		0.00%	0%	0%
	19:00	USD	Fed Summary of Economic Projections				
	19:30	USD	FOMC Press Conference				
	20:00	ARS	CPI (MoM)	Aug	3.0%		1.9%
	21:00	USD	Total Net TIC Flows	Jul			-67.9B
	N/A	BRL	COPOM Rates Decision		2.00%	2%	2%
	23:45	NZD	GDP (QoQ)	2Q		-12.5%	-1.6%
17-Sep	00:50	JPY	Japan MoF Weekly Security Flow				
	01:30	SGD	Non-Oil Domestic Exports (YoY)	Aug		2.6%	6%

	02:30	AUD	Employment Change	Aug	-90k	-40k	114.7k
	02:30	AUD	Unemployment Rate	Aug	7.9%	7.7%	7.5%
	N/A	JPY	BoJ Rates Decision		-0.10%		-0.1%
	N/A	JPY	BoJ 10y Yield Target		0.00%		0%
	07:30	JPY	BoJ Press Conference				
	08:20	IDR	BI Rates Decision		4.00%	4%	4%
	N/A	TWD	CBC Rates Decision		1.125%	1.125%	1.125%
	09:00	EUR	Italian Trade Balance	Jul			6232m
	09:00	EUR	ECB's Rehn spks (Economy and Monetary Policy)				
	09:00	EUR	ECB's de Guindos spks (Economy)				
	10:00	EUR	Construction Output (MoM)	Jul			4%
	10:00	EUR	CPI (YoY)	Aug F	-0.2%	-0.2%	-0.2%
	10:00	EUR	CPI Core (YoY)	Aug F	0.4%	0.4%	0.4%
	12:00	GBP	BoE Rates Decision		0.10%	0.1%	0.1%
	13:30	CAD	ADP Employment Change				
	13:30	USD	Housing Starts	Aug		1480k	1496k
	13:30	USD	Housing Starts (MoM)	Aug	-11.6%	-1.1%	22.6%
	13:30	USD	Philadelphia Fed Business Outlook	Sep		15	17.2
	13:30	USD	Initial Jobless Claims			840k	884k
	N/A	ZAR	SARB Rates Decision		3.25%	3.25%	3.5%
18-Sep	00:30	JPY	CPI (YoY)	Aug	0.2%	0.2%	0.3%
	00:30	JPY	CPI Ex Fresh Food (YoY)	Aug	-0.4%	-0.4%	0%
	00:30	JPY	CPI Ex Fresh Food, Energy (YoY)	Aug	-0.1%	-0.1%	0.4%
	05:00	SEK	Valueguard/HOX House Prices				
	07:00	GBP	Retail Sales (MoM)	Aug	0.1%	0.5%	2%
	07:00	EUR	German PPI (YoY)	Aug	-1.4%	-1.3%	-1.7%
	07:45	EUR	French Wages (QoQ)	1Q F			0.9%
	09:00	EUR	Italian Current Account Balance	Jul			3430.9m
	09:00	EUR	Euro-Area Current Account	Jul			20.7B
	09:00	EUR	Italian Industrial Orders (MoM)	Jul			23.4%
	10:15	EUR	ECB's de Guindos Hernandez de Cos spk				
	11:30	RUB	CBR Rates Decision		4.25%	4.25%	4.25%
	13:30	USD	Current Account Balance	2Q		-158	-104.2
	13:30	CAD	Wholesale Trade Sales (MoM)	Jul			18.5%
	13:30	CAD	Retail Sales (MoM)	Jul			23.7%
	15:00	USD	Leading Index	Aug	1.1%	1.3%	1.4%
	15:00	USD	Univ. of Michigan Confidence	Sep P		75	74.1
	15:00	USD	Fed's Bullard (non-voter) spks (Covid-19)				
	15:00	EUR	ECB's Schnabel spks				
	N/A	UAH	GDP (YoY)	2Q F			-11.4%

Source: Morgan Stanley Research, Bloomberg

Government Bond Ratings

Exhibit 186: Government Bond Ratings

		Aaa/ AAA	Aa1/ AA+	Aa2/ AA	Aa3/ AA-	A1/ A+	A2/ A	A3/ A-	Baa1/ BBB+	Baa2/ BBB	Baa3/ BBB-	Ba1/ BB+	Ba2/ BB	Ba3/ BB-	B1/ B+	B2/ B	B3/ B-	Below B3/ B-
US	Moody	STA																
	S&P		STA															
	Fitch	STA																
JPN	Moody					STA												
	S&P					STA												
	Fitch						STA											
UK	Moody			STA														
	S&P			NEG														
	Fitch				NEG													
GER	Moody	STA																
	S&P	STA																
	Fitch	STA																
FRA	Moody			STA														
	S&P			STA														
	Fitch			NEG														
AUT	Moody		STA															
	S&P		STA															
	Fitch		STA															
NETH	Moody	STA																
	S&P	STA																
	Fitch	STA																
FIN	Moody		STA															
	S&P		STA															
	Fitch		STA															
BEL	Moody				STA													
	S&P			STA														
	Fitch				NEG													
SPA	Moody								STA									
	S&P							POS										
	Fitch							STA										
ITA	Moody										STA							
	S&P									NEG								
	Fitch										STA							
IRE	Moody						STA											
	S&P				STA													
	Fitch					STA												
POR	Moody										STA							
	S&P										STA							
	Fitch									STA								
GRE	Moody													STA				
	S&P														POS			
	Fitch												STA					
Australia	Moody	STA																
	S&P	STA																
	Fitch	STA																
New Zealand	Moody	STA																
	S&P		POS															
	Fitch		STA															
Canada	Moody	STA																
	S&P	STA																
	Fitch	STA																

Source: Morgan Stanley Research, Moody's, Standard and Poor, Fitch
STA: Outlook Stable, NEG: Outlook Negative, DEV: Outlook Developing, OW-: On Watch Negative, POS: Outlook Positive, SD: Selective Default

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Equal-weight/Hold	**1426**	**44%**	**340**	**45%**	**24%**	**676**	**46%**
Not-Rated/Hold	**4**	**0%**	**1**	**0%**	**25%**	**3**	**0%**
Underweight/Sell	**555**	**17%**	**83**	**11%**	**15%**	**224**	**15%**
TOTAL	**3,267**		**763**			**1471**	

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SCI 最全写作攻略	TEM4/TEM8 专四专八备考资料	教师资格证面试试讲万能模板
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Vlog 制作最全攻略	超强 PR 模板	42 套卡通风 PPT 模板
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好用到极致的 PPT 素材	128 套中国风 PPT 模板	32 套 MBE 风格 PPT 模板
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注：太多了，无法全部一一列出。。。

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